Fiscal Autonomy in Scotland

The case for change and options for reform

Taking forward our National Conversation

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Foreword by the Cabinet Secretary for Finance and Sustainable Growth

In May 2007, the people of Scotland voted for the country's first ever SNP Government. This decision reflected a growing ambition nationwide to improve the economic prospects of our country and the opportunities for our people.

In government we have responded to this demand, placing our core Purpose of increasing sustainable economic growth at the heart of our actions and our policies. We have consistently used every lever available to raise sustainable economic growth and break the cycle of decades of relative economic underperformance. And, in the face of the current global economic crisis affecting all advanced economies, we have redoubled our efforts to protect jobs, incomes and businesses across Scotland.

It is clear that the Scottish economy faces its greatest challenge in decades. However, the impact of the economic crisis has starkly exposed the limits of Scotland's current fiscal framework.

The right response to the present situation is to deliver a substantial, immediate and well-targeted fiscal stimulus, supporting growth, jobs and confidence throughout the economy. But, within the current framework, Scotland's Government is tied to a fixed budget determined by Westminster. The Scottish Government has no scope to borrow prudently or to boost spending, and it has very limited scope to cut taxes to spur growth. In short, at the time of Scotland's greatest economic need, its Government does not have all the powers to properly protect its citizens and businesses. This cannot be in the best interests of the Scottish economy; not now and not for the long-term. That is why this debate on Scottish fiscal autonomy is important.

More widely, the global economic crisis has called into question fundamental aspects of economic policy in the advanced economies that were previously regarded as settled. The role of the state, the scope of financial regulation, the objectives of fiscal and monetary policy and arrangements for international economic and financial coordination are all being questioned anew.

Globally, there is now underway a review of the structure and aims of economic policy. Existing frameworks and policies in many advanced nations, large and small, have been found wanting. This is the time to shape new and better economic institutions. It is in that spirit that we must consider the right arrangements for Scotland's long-term success.

The Scottish Government firmly believes that for Scotland to achieve its full economic potential, it must have control of the economic levers of an independent country. This paper sets out the reasons why we believe this is the case and considers possible options for reform. We seek to enable the broadest and deepest debate possible on the future of the Scottish economy; a National Conversation uniting businesses, trade unions, government, citizens, universities and colleges and the third sector.

This paper is an important contribution to the debate on the future of Scotland. It will be followed by discussions and further papers setting out how the Scottish Government would use the full range of levers to deliver greater prosperity for Scotland. Our aim is to provide the best possible evidence to enable the people of Scotland to make informed choices about the future of Scotland, and to agree how best to secure Scotland's full potential.

John Swinney MSP
Cabinet Secretary for Finance & Sustainable Growth

Executive Summary

- *Choosing Scotland's Future* opened a National Conversation on the type of government which best equips Scotland for the future. This conversation is even more important in the current economic climate. Scotland needs a fiscal framework that enhances our country's long-term competitiveness and our ability to respond swiftly and decisively to short-term economic pressures.

- The *Government Economic Strategy* set out the scale of the challenge in putting Scotland on a path of higher sustainable economic growth. Scotland's economic growth in recent decades has under-performed relative to both the UK and other comparable European countries. Over 30 years (1977 to 2007), Scotland's annual average growth in GDP was 1.9%, well below that of comparable European countries, and significantly below the UK average of 2.4%.

- The Scottish Government is already taking forward a wide range of actions through the Government Economic Strategy and Economic Recovery Programme to meet this challenge head-on, but we lack the full range of economic levers that other countries have.

- The current framework significantly constrains the ability of the Scottish Government to boost Scotland's long-term competitiveness through, for example, introducing a simpler and more competitive tax regime. It also constrains the ability to take short-term measures to stabilise the economy, through, for example, tax cuts or significant increases in public investment. The ability to stabilise the economy in the face of a downturn has been brought into sharp focus by recent events.

- There is now a growing consensus on the urgent need to enhance the taxation, spending and borrowing responsibilities of the Scottish Parliament.

- This paper sets out the main options for reform which are assessed against a number of key criteria. The options are:

  - full fiscal autonomy in an independent Scotland;
  - a position of 'devolution max' – full fiscal autonomy within the UK;
  - creating enhanced devolution;
  - assigning revenues to the Scottish Parliament; and
  - continuing with or marginally changing the current framework.

- The view of the Scottish Government is clear. This Government believes that independence is the best way forward for Scotland and would provide the assured constitutional structure to deliver increasing sustainable economic growth.

- The publication of this paper is part of the National Conversation. The Scottish Government welcomes views on the issues raised in this and planned subsequent papers which will consider specific policy options under independence, such as establishing a competitive corporation tax regime, a Scottish oil fund and management of government borrowing.

1 Introduction and overview

Chapter Summary

- *Choosing Scotland's Future* inspired a National Conversation on the type of government which best equips Scotland for the future.
- This conversation is even more important given the challenges presented by the current economic climate.
- Scotland needs a fiscal framework that enhances Scotland's long-term competitiveness and our ability to respond swiftly and decisively to short-term economic pressures.
- This Government believes that independence is the natural state for nations like Scotland and that with greater responsibility for its own affairs and fiscal framework, Scotland could move from a position of relative underperformance and instead match, and even surpass, the higher levels of long-term growth experienced by other, similar nations.
- The National Conversation is about listening and responding to the views of people across Scotland and further contributions to the debate are welcomed.

Introduction

The National Conversation in context

1.1 *Choosing Scotland's Future*[1], published in August 2007 shortly after the election of Scotland's first SNP Government, acted as the starting point for the National Conversation to allow the people of Scotland to debate, reflect and then decide on the type of government which best equips Scotland for the future. The National Conversation is all about creating the best environment for Scotland to flourish and Scotland's economic responsibilities, including tax, spending and borrowing, are central to this debate.

1.2 The need for a revised fiscal framework to enable the Scottish Government to take decisive action to cut taxation, re-prioritise expenditure and create a more competitive business environment has long been acknowledged by various academics, commentators and politicians from across the political spectrum. The importance of this debate has been thrown into stark relief by the recent sharp deterioration in the global economy. Scotland – in common with the rest of the world – faces significant challenges in responding to current economic conditions. The global economic slowdown is now being felt in Scottish homes and high streets and, with the UK now officially in recession, this is likely to continue over the months ahead.

1.3 The overriding Purpose of this Government has been clear from our first day in office: to focus the Government and public services on creating a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth. A fiscal framework that enhances Scotland's long-term competitiveness and ability to respond swiftly and decisively to short-term economic pressures and circumstances, such as those Scotland currently faces, is vital to achieving this Purpose.

[1] Choosing Scotland's Future http://www.scotland.gov.uk/Publications/2007/08/13103747/0

1.4 The Scottish Government has already set out a wide range of actions as part of our Economic Recovery Programme[2], taking the steps we can, within our current responsibilities, to support small businesses and ordinary households, to maximise jobs and investment and to ensure the Scottish economy is well positioned for recovery.

1.5 However, there is no doubt much more could be done if Scotland had additional economic powers. The current economic conditions have demonstrated more clearly than ever before the importance of Scotland taking responsibility for its own economic success. The National Conversation is the vehicle to take forward this debate.

1.6 People across Scotland have been engaging in the National Conversation throughout 2008 and early 2009. Scotland's civic society, businesses, trade unions, universities and colleges are all taking part in discussions which will help shape Scotland's future. Hundreds of people have attended public events with the First Minister and Cabinet, and the churches, the voluntary sector and Scotland's young people have all made substantial contributions as the momentum of the Conversation has increased.

1.7 Through the National Conversation a range of views have emerged about what is best for the country. The National Conversation is therefore open to all views across the range of issues that face Scotland. This Government is listening, and responding to, the views of people across Scotland and welcomes further contributions to the debate (see Box 1).

Box 1 – National Conversation: What you have told us

The National Conversation has already helped the Scottish Government to get a clearer picture of the issues of importance to Scottish citizens. There have been over 460,000 hits on the website, 35,000 people have read the white paper on-line and 4,000 have left comments on the blog. Around 2,500 people also attended 22 public events last year. We have started 2009 with a public event in Dundee and future events have been planned for across Scotland throughout the year. Through this extensive engagement it has become clear that the public are seeking change and greater financial independence for Scotland.

The public's comments have recognised that: more financial independence will create the right conditions for growth in the Scottish economy; entrepreneurship could be encouraged through competitive tax rates; and Scotland could make decisions about policies based on what is right for Scotland.

Reform Scotland, the non party aligned Scottish think tank, in its contribution to the National Conversation recognised that: "There is now a growing consensus that the current system, based on a block grant determined largely by application of the Barnett Formula, must change. It is unbalanced because although the Scottish Government has control over 60% of government expenditure in Scotland, it has very limited responsibility for raising the revenue required to meet those spending commitments other than the local taxes (council tax and business rates) collected by local government."

The submission goes on to say: "The lack of revenue-raising or borrowing powers undermines the Scottish Parliament's autonomy and accountability. Tax rates cannot be set at levels appropriate to Scotland. So there is no way of creating a more attractive fiscal framework in Scotland to boost economic growth. This lack of fiscal powers limits the

[2] The Scottish Government's Response to the First Annual Report of the Scottish Council of Economic Advisors
http://www.scotland.gov.uk/Publications/2009/01/15111700/0

Scottish Government's ability to respond to the current 'credit crunch' through measures such as a reduction in the tax burden. The lack of borrowing powers further limits the room for manoeuvre and makes it harder to pay for important infrastructure projects."

1.8 The fiscal framework that currently exists in Scotland is largely a legacy of the constitutional settlement prior to devolution. We believe that the time is now right for a discussion about what fiscal framework is best for Scotland. The Government recognises that there is already a vigorous debate on the funding of the public sector in Scotland, and the economic and other benefits of various models. The Government believes that this work indicates an impetus towards change and that there is strong and growing support for greater tax, spending and borrowing responsibilities – commonly known as 'fiscal autonomy' – for the Scottish Parliament.

1.9 Having the ability to make decisions both to build long-term competitiveness and to respond to short-term economic challenges is essential if Scotland is to fulfil its potential as a nation. We believe that options short of independence would not fully unlock Scotland's economic potential.

Taking the Conversation forward

1.10 This paper takes the National Conversation on tax, spending and borrowing – 'fiscal autonomy' – to the next stage. The paper:

- explores the rationale for improving current arrangements;
- identifies and reviews the options for reform, to enable the people of Scotland to make informed decisions;
- makes clear the Scottish Government's preferred position; and
- seeks further contributions to the debate.

1.11 Unlike other reviews of the current fiscal arrangements for the Scottish Parliament, this paper examines the full spectrum of options for reform, from maintaining the current framework through to full fiscal autonomy in an independent Scotland. The National Conversation is inclusive of all opinions on the best way forward for Scotland.

1.12 Beyond this exploration of the case for change and options for reform, a series of discussions will be held and further papers will be published setting out how the Scottish Government would use economic policy to deliver a step-change in economic growth for Scotland.

Overview

1.13 The structure of the paper is as follows:

- Chapter 2 outlines the long-term and short-term trends for Scotland's economic growth and highlights the substantial opportunities for Scotland that could flow from greater responsibility over tax, spending and borrowing.

- Chapter 3 describes the current framework for tax, spending and borrowing in Scotland and examines the constraints imposed by the current arrangements.

- Chapter 4 goes on to examine a range of options for reform of tax, spending and borrowing responsibilities in Scotland, with Chapter 5 reviewing these options against key criteria, identifying which options deliver greater growth potential for Scotland.

- Finally, Chapter 6 concludes and raises a series of issues on which views would be welcome to identify a way ahead for Scotland.

2 Delivering our Purpose: Sustainable economic growth

Chapter Summary

- The *Government Economic Strategy*[3] set out the scale of the challenge in putting Scotland onto a higher sustainable economic growth path.

- The challenge is even greater given the current global economic downturn which is affecting countries large and small, and economies need to respond flexibly to these challenges and consider the long-term implications for policies and institutions.

- The Scottish Government is already taking forward a series of initiatives through the *Economic Recovery Programme* to meet this challenge head-on, but the Scottish Government lacks the full range of economic levers to support increased sustainable economic growth.

- There is a growing consensus that there is a need for reform of tax, spending and borrowing responsibilities for the Scottish Parliament.

- The view of the Scottish Government is clear. The Government believes that a fiscal framework that enables long-term competitiveness and short-term flexibility is vital to achieving the Purpose and that independence is the best option to deliver this.

Introduction

2.1 Achieving increased sustainable economic growth for Scotland means building a dynamic and growing economy that will provide prosperity and opportunities for all, while ensuring that future generations will also enjoy a better quality of life.

2.2 This chapter outlines the long-term and short-term trends for Scotland's economic growth and highlights the size of the challenge facing Scotland in the years ahead.

The Economic Challenge

Targets

2.3 The *Government Economic Strategy*, published in 2007, set out the scale of the challenge in putting Scotland on to a higher sustainable growth path and the targets that have been set to help meet that challenge.

2.4 The strategy identifies two clear, time-bound targets for increasing sustainable economic growth:

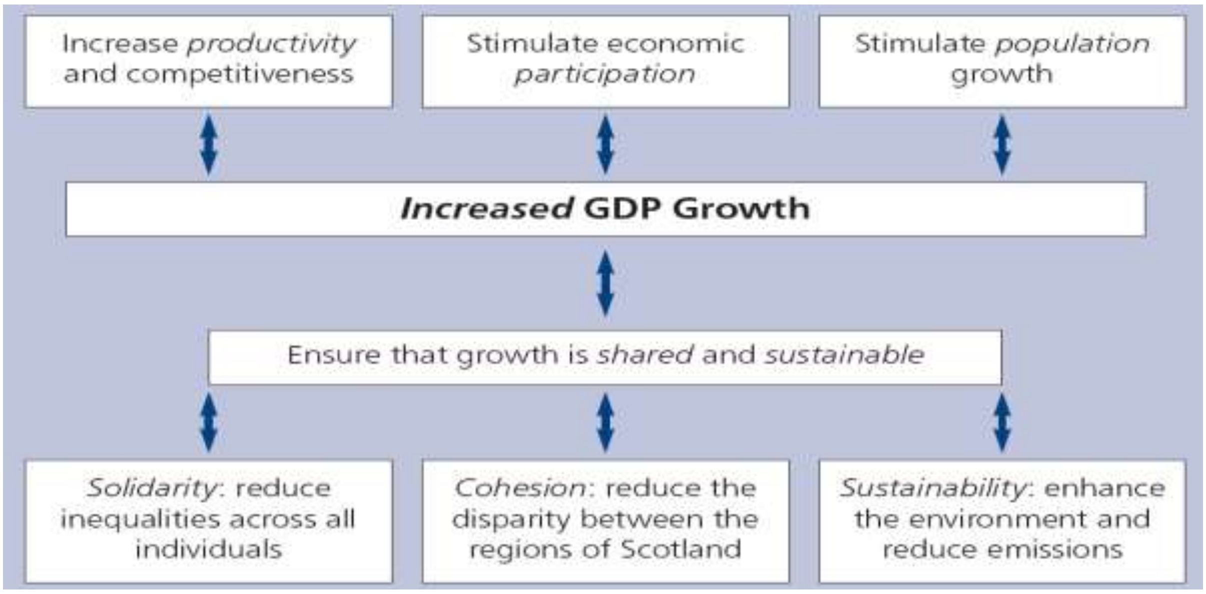
- to raise Scotland's GDP growth rate to the UK level by 2011; and

- to match the GDP growth rate of the small independent EU countries by 2017.

[3] The Government Economic Strategy http://www.scotland.gov.uk/Publications/2007/11/12115041/0

2.5 To achieve increased sustainable economic growth, Scotland needs to drive up its performance in relation to three key components: productivity, participation and population. This growth should also satisfy three desired characteristics – solidarity, cohesion and sustainability as illustrated in Figure 1. The Scottish Government has set targets relating to all these areas.

Figure 1 – The Economic Challenge



Source: Government Economic Strategy

Comparisons of long-term performance

2.6 Scotland's economic growth in recent decades has under-performed relative to both the UK and other European countries. Over the last 30 years (1977 to 2007), Scotland's annual average GDP growth of 1.9%, has lagged behind the UK's growth rate of 2.4%, which itself has been outperformed by comparable European countries such as Ireland, Norway and Finland, who have experienced average growth rates of 5.4%, 3.1% and 2.9%, respectively. These decades of relatively poor performance have led to missed opportunities for Scotland, and we now clearly lag behind many independent EU countries on a range of economic indicators.

2.7 For example, economic growth in Norway has been consistently higher than in Scotland over the past decade, with GDP per capita in 2007 approximately 50% higher than in the UK[4]. In addition, the Norwegian Government has established a significant oil fund for the benefit of future generations valued at approximately £200 billion as at September 2008[5]. In contrast, Scotland – Europe's other major oil producer – does not have such a fund and instead all the tax revenues from the North Sea flow to the UK Exchequer.

2.8 Meanwhile, notwithstanding the immediate economic challenges in Ireland, the Irish economy has generated strong, sustained growth over the past three decades and GDP per capita is approximately 30% higher than in Scotland.

[4] OECD, OECD.StatExtracts: http://stats.oecd.org/WBOS/index.aspx
[5] As at 30 September 2008, Source: NBIM Quarterly Report Q3, 2008 – Table 5.1.
http://www.norges-bank.no/templates/reportroot____65330.aspx

2.9 Table 1 summarises average GDP growth rates of the UK and a number of European countries over the period 1977 to 2007. The results show that economic growth in many European countries has been consistently higher than in Scotland and the UK over the past 30 years.

Table 1 – Economic Growth: Scotland, the UK and Comparable European Countries

	Average Annual Growth Rates		
	5 Year (2002 – 2007)	**10 Year (1997 – 2007)**	**30 Year (1977 – 2007)**
Austria	2.5%	2.5%	2.4%
Denmark	2.0%	1.9%	2.0%
Finland	3.5%	3.6%	2.9%
Iceland	5.4%	4.5%	3.4%
Ireland	5.5%	6.9%	5.4%
Luxembourg	4.6%	5.3%	4.5%
Norway	2.6%	2.4%	3.1%
Portugal	1.0%	2.0%	2.7%
Sweden	3.2%	3.2%	2.3%
Scotland	**2.3%**	**2.2%**	**1.9%**
UK	**2.7%**	**2.9%**	**2.4%**

Source: OECD, Scottish Government

2.10 Over the long-term, independent countries have been able to use a range of economic and fiscal strategies to maximise the benefits of their respective competitive advantages: world-class performance in key economic sectors; deep pools of skills and human capital; natural resource endowments; and the targeting of any areas that need greater support.

Comparisons of short-term performance and the global economic downturn

2.11 The global slowdown and financial crisis have weakened the performance of the Scottish economy. For many, the current economic climate is the most serious for a generation. For young people, these are the worst economic conditions they have ever faced.

2.12 Scotland is not alone in this respect. Countries, both large and small, face difficult and challenging times ahead. However, despite this environment, the Scottish Government remains focused on matching or out-performing the long-term economic success of other European countries.

2.13 During 2008 a number of economies, including Germany, Japan, Denmark, Ireland, Italy, Sweden and the UK, fell into recession as a result of the global economic slowdown.

2.14 Forecasts published by the Organisation for Economic Co-operation and Development (OECD) in November 2008 highlight that the global economic slowdown is likely to affect economies of all sizes in the coming years. The OECD forecasts that the UK economy will be particularly affected by the global slowdown[6]. The International Monetary Fund (IMF) estimates that GDP in the UK will fall by 2.8% in 2009 – the biggest drop amongst the major economies studied[7]. The European Commission estimates that the economic downturn may not be so severe in some EU economies such as Finland and Austria[8]. Outside the EU, the OECD forecasts that Norway will be one of the economies most insulated from the general slowdown.

2.15 It is currently difficult to determine what lasting impact the global economic slowdown will have on the future long-term economic growth performance of economies across the world. Unlike Scotland, independent countries have the opportunity to implement a wide range of flexible, short-term economic strategies to address the effects of the economic downturn on their economies and, just as importantly, put in place policies which will ensure that when the world economy recovers, they are in the best position to take advantage of new opportunities.

2.16 Once again, Norway offers a useful insight into the opportunities available to independent and dynamic economies, even in the face of a sharp global downturn. Norway's economic performance has been, and is likely to be, cushioned to an extent by its large sovereign oil fund. The principal aim of the Norwegian oil fund is sustainable long-term wealth management. However, an important feature of its design is that it can assist in stabilisation of the wider fiscal and economic position when necessary. Many other advanced economies have had to finance a fiscal stimulus package by increasing public sector net borrowing and net debt. This is not the case in Norway where, because of its prudent use of its natural resource wealth and the building of a large fund of assets, Norway is not only withstanding the global slowdown better than many other countries but it is also well placed to resume strong growth as the world economy recovers.

2.17 The global slowdown is also putting pressure on public sector finances – nowhere more so than in the UK. In November 2008, the OECD estimated that even before the effects of the fiscal stimulus announced in the UK Government Pre-Budget Report (PBR) is taken into consideration, the UK would have one of the largest budget deficits in Europe next year. In Ireland, the only EU country anticipated to have a larger budget deficit in 2009, by 2010 the ratio of general government net financial liabilities[9] to GDP is still forecast to be only half that of the UK (19.8% compared to 43.0%)[10].

2.18 The PBR forecasts show that net borrowing will be £118 billion in 2009/10 and that total net debt will rise to over £1 trillion in 2012/13[11]. The Institute for Fiscal Studies (IFS) estimates that these forecasts may be overly optimistic. Even if the PBR forecasts are correct, the IFS estimate that UK Government spending may have to be cut by an extra £20 billion by the end of the next UK Parliamentary term to repair the public finances and public sector debt may not return to pre-crisis levels for more than 20 years[12].

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[6] OECD Economic Outlook, Number 84, Organisation for Economic Co-operation and Development - www.oecd.org
[7] IMF World Economic Outlook Update, 28 January 2009 - http://www.imf.org/external/pubs/ft/weo/2009/update/01/index.htm
[8] European Commission, Directorate-General for Economic and Financial Affairs, Interim Forecast 2009 - http://ec.europa.eu/economy_finance/pdf/2009/interimforecastjanuary/interim_forecast_jan_2009_en.pdf and OECD Economic Outlook, Number 84, Organisation for Economic Co-operation and Development - www.oecd.org
[9] General government net financial liabilities is a measure of long-term indebtedness
[10] OECD Economic Outlook, Number 84, Organisation for Economic Co-operation and Development - www.oecd.org
[11] Pre-Budget Report (PBR) 2008, HM Treasury - www.hm-treasury.gov.uk
[12] IFS Green Budget 2009, Institute for Fiscal Studies: London - www.ifs.org.uk

2.19 As a result of the current global economic downturn and the associated financial crisis, large and important elements of economic policy and institutional systems and structures are under review throughout the advanced economies (see Box 2). There is a widespread acceptance of the need for major reforms to the framework for economic policy in the United States, the UK and other economies. It is against this backdrop that the case for greater fiscal autonomy for Scotland must also be considered, as well as the potential benefits that it could bring in terms of increased sustainable economic growth, greater responsiveness and flexibility of policy.

Box 2 – The global economic downturn and financial crisis

The causes and the impact of the global economic slowdown have raised important, wider questions about the setting of economic policy in advanced economies. This is forcing a reappraisal of policy and institutional frameworks in several areas, including: the role of the state; the scope of financial regulation; the objectives of monetary and fiscal policy; and the arrangements for international economic and financial coordination.

In terms of the **role of the state**, governments in many advanced economies have taken large stakes in major companies affected by the 'credit crunch'. These stakes have been mostly in the financial services sector. This expansion of the role of the state within the economy has been viewed by many governments as temporary but entirely necessary to uphold the stability of the financial system and other strategically important industries.

The UK Government has injected billions of pounds of public capital into the financial sector including direct support for three major banks (HBOS, Lloyds TSB and RBS), following on from the nationalisation of Northern Rock and part nationalisation of Bradford and Bingley in 2008. The US Government has also injected public capital into its financial sector, including support for a major insurer. In February 2009 the U.S. Government also announced plans to establish a new $2 trillion fund to stabilise the financial sector[13]. Meanwhile governments in many European states, including Germany, France, Italy, Sweden[14] and Ireland[15] have injected public capital into the banking sector. The Norwegian Government introduced a facility in November 2008 where it will offer up to NOK 350 billion (£34.4 billion) of government bonds to banks against collateral, in order to improve liquidity in the market. Two further interventions were announced in February 2009. A NOK 50 billion (£5 billion) recapitalisation fund was established to strengthen banks' core capital to help maintain normal lending activity. A NOK 50 billion (£5 billion) bond fund was created to help industrial companies access funding from bond markets[16].

Much of the disruption in financial markets during 2008 and 2009 has arisen from market failures in unregulated and poorly regulated parts of the financial services sector, including hedge funds and derivatives markets. Heavy exposure to these complex, non-transparent instruments led to major losses for banks and damaged confidence throughout the financial system. Certain parts of the financial sector that were previously regarded as innovative and largely stable are now likely to come within the **broader scope of financial regulation**. New regulatory initiatives may also include tougher financial reporting standards and adjustments to the capital ratios of financial institutions over the economic cycle.

[13] US Treasury - Financial Stability Plan Fact Sheet (February 2009)
[14] The Swedish government moved to stabilise its financial system by guaranteeing up to £138 billion of new bank borrowing and creating a £1.4 billion fund to help recapitalise its banks.
[15] The Irish government was the first to guarantee all deposits, bonds and debts in its six main banks for two years. Ireland has now also approved a £5.5 billion plan for recapitalising its banking sector.
[16] Norwegian Ministry of Finance Press Release No. 17/2009 (08.02.09) available at: http://www.regjeringen.no/en/dep/fin/press-center/Press-releases/2009/norway-presents-new-measures-for-industr.html?id=545244

Recent events in the global economy may also lead to a widespread reappraisal of the **objectives of monetary policy**. Policymakers and commentators have been aware for several years of the potential risks to stability arising from asset price inflation in housing and securities markets. However, controlling asset prices has not been within the explicit mandate of central banks such as the US Federal Reserve, the European Central Bank and the Bank of England. The severity of the credit crunch is likely to lead to a re-casting of the objectives of monetary policy to place greater emphasis on financial market and asset price stability.

Lastly, the arrangements for **international economic and financial coordination** are also coming under considerable scrutiny. For several years institutions such as the International Monetary Fund and the Bank for International Settlements have warned of the risks to stability arising from the sustained recycling of balance of payments surpluses (e.g. from China and oil producing economies) back into economies with a payments deficit (e.g. the United States and United Kingdom). Many commentators argue that this trend contributed to the unsustainable growth in domestic demand and in asset prices in some advanced economies. Governments and policymakers in the advanced nations have also recently invoked the need for a 'new Bretton Woods' settlement to help maintain stability and equilibrium in global flows of trade and investment.

Opportunities to meet the challenge

2.20 Higher sustainable economic growth is the key that can unlock Scotland's full potential and enrich Scotland as a whole.

2.21 The Scottish Government is already taking important steps to enhance Scotland's economic performance. The Government's aim in the current economic situation is to protect jobs and maximise investment and ensure Scotland's economy is well positioned for recovery. Focusing on sustainable growth and Scotland's strengths – a highly skilled workforce, substantial natural resources and a competitive cost base – will give Scotland a solid foundation on which to take early advantage of the recovery. Central and local government as well as the wider public sector are all focused on delivery of higher sustainable economic growth.

2.22 The Scottish Government's Economic Recovery Programme has focused resources on ensuring that the current powers of the Scottish Parliament are channelled to deliver for families and businesses across Scotland[17].

2.23 However, currently the Scottish Government is restricted in the range of policy options open to it. Opportunities are limited to set competitive policies, particularly taxation, and to use the full range of fiscal and economic policy levers to complement the specific strengths of the Scottish economy and address any weaknesses.

2.24 The Scottish Government has no doubt that Scotland would be better placed to deal with current and future economic challenges if it had greater fiscal autonomy. Indeed, without greater autonomy over the levers of the economy, generating a step-change in Scotland's growth path is made more difficult.

2.25 The *Government Economic Strategy* identified a broad set of economic levers that would accelerate sustainable growth in Scotland which this Government considers are vital to support the Scottish economy:

[17] The Scottish Government's Response to the First Annual Report of the Scottish Council of Economic Advisors http://www.scotland.gov.uk/Publications/2009/01/15111700/0

- Devolution of full responsibility for *economic and fiscal policy,* allowing the Scottish Government to tailor a tax environment suited to attracting increased investment to Scotland and increasing competitiveness which, in turn, will lead to a faster growing economy, more and better paid jobs and higher government revenues;

- The Scottish Parliament taking responsibility for *oil and gas reserves,* allowing optimisation of long-term production and the possibility to invest a portion of this massive resource in an oil fund for the benefit of Scotland today and in the future;

- Further devolution of *employment policy,* improving accountability and providing greater coherence between economic and employment policy, allowing the balance between workers' rights, the level of minimum wage and the need for a flexible workforce, to reflect Scottish labour market conditions; and

- Greater *Scottish representation in Europe,* allowing particular circumstances to be addressed in the negotiation, transposition and enforcement of EU regulation.

2.26 There is a growing consensus that there is a need for reform of tax, spending and borrowing responsibilities for Scotland and that some form of greater fiscal autonomy is desirable[18]. There is, however, still considerable debate about the impact of the various fiscal autonomy options on Scotland and which is most appropriate for delivery of increased sustainable economic growth.

2.27 The success of independent European countries, as outlined above, demonstrates the potential benefits of greater fiscal autonomy. The economic success of the fiscally autonomous Basque Country relative to the rest of Spain, where GDP per capita is approximately 30% higher than the Spanish average, shows how significant autonomy within a larger state can also confer an advantage[19].

2.28 As well as evidence from international comparisons, a number of academic studies have attempted to measure the effects that decentralisation can have on economic growth[20]. Although not all evidence is conclusive, some studies do show positive effects. However, what appears to be most important are the policies, type of economy and society created with fiscal autonomy in determining economic success and prosperity.

2.29 For example, a number of European countries have taken advantage of the benefits of setting a competitive corporation tax rate to make their country a more attractive location for doing business. Recent studies have demonstrated the positive impact that a competitive corporation tax strategy can have on productivity and economic growth[21]. The Scottish Government has made it clear that a fiscally autonomous

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[18] See for example: Reform Scotland, Nov 2008, "Fiscal Powers"; David Hume Institute, Nov 2008, "Options for Scotland's Future – the Economic Dimension"; The Steel Commission, March 2006, "Moving to Federalism – A New Settlement for Scotland" and IPPR, July 2008, "Fair Shares? Barnett and the Politics of Public Expenditure".
[19] Instituto Nacional de Estadistica National Accounts www.ine.es/
[20] See MacDonald R., and Hallwood P., 2006, "The Economic Case for Scottish Fiscal Autonomy: With or Without Independence", The Policy Institute, Edinburgh; Imi, A., 2005, "Decentralisation and Economic Growth Revisited: An Empirical Note"', Journal of Urban Economics, Vol. 57, pp. 449 – 461; Stansel DB., 2005, "Local Decentralisation and Economic Growth: A Cross-Sectional Examination of US Metropolitan Areas", Journal of Urban Economics, Vol. 57, pp. 55 – 72 and Thieβen, U., "Fiscal Decentralisation and Economic Growth in High-Income OECD Countries", Fiscal Studies, Vol. 24, pp. 237-274.
[21] Lee Y., and Gordon RH., 2005, "Tax structure and Economic Growth", Journal of Public Economics, Vol. 89, pp. 1027-1043; Linn H., and Russo L., 2002, "Growth effects of capital income taxes: how much does endogenous innovation matter?", Journal of Public Economic Theory, Vol. 4, pp. 613 – 640; Schwellnus C., and Arnold J., 2008, "Do Corporate Taxes Reduce Productivity and Investment at the Firm Level?: Cross-country Evidence from the Amadeus Dataset", OECD Economics Department Working Paper, Number 641; and Vartia L., 2008, "How do Taxes Affect Investment and Productivity? An Industry-Level Analysis of OECD Countries", OECD Economics Department Working Paper, Number 656.

Scotland would pursue the full range of policies to make Scotland an attractive place for doing business, including simplification and greater certainty in our tax system and a phased reduction in corporation tax to levels significantly below the UK. In addition, Norway, Alberta and Alaska have benefited from being able to manage their natural resources in a responsible manner through the establishment of oil funds. A key objective of the Scottish Government under fiscal autonomy would be the establishment of an oil fund for Scotland for the benefit of current and future generations.

Conclusion

2.30 Sustainable economic growth for Scotland means building a dynamic and growing economy that will provide prosperity and opportunities for all, while ensuring that future generations will also enjoy a better quality of life. The *Government Economic Strategy* and *Economic Recovery Programme* set out how, within the current economic climate, the Scottish Government intends to deliver a long-term structural improvement in Scotland's economy. The experience of other countries however, highlights that more can be done with access to the full range of fiscal policies and economic levers.

2.31 The view of the Scottish Government is clear – that a fiscal framework which enables the Scottish Government to fully enhance Scotland's long-term competitiveness and to respond swiftly and decisively to short-term economic pressures and circumstances, is vital to achieving the Purpose of increasing sustainable economic growth. Independence gives Scotland that opportunity.

2.32 The next chapter will go on to examine the current fiscal framework and the constraints and limitations this places on the potential growth of the Scottish economy.

3 Current framework for tax and spending in Scotland

Chapter Summary

- Under the current devolution settlement the Scottish Parliament has a significant degree of spending autonomy but very limited tax revenue raising autonomy, no meaningful borrowing autonomy, and no responsibility over monetary policy, competition policy, company law or regulation of financial markets.
- The current framework significantly constrains the ability of the Scottish Government to boost Scotland's long-term competitiveness through, for example, introducing a more competitive tax regime, and from taking short-term measures to stabilise the economy through, for example, tax cuts or increases in spending.
- The consequence is that there is general consensus that the current framework requires reform.

Introduction

3.1 Before considering the options for any future fiscal framework for Scotland, it is important to have a clear picture of the current framework for tax, spending and borrowing under the existing devolution settlement and to understand how well this meets the economic challenges faced by Scotland.

3.2 This chapter describes the current arrangements based on the Scotland Act 1998[22], examines Scotland's fiscal position and identifies the constraints these arrangements place on realising Scotland's growth potential.

Scotland's Current Fiscal Framework

3.3 This section outlines the current arrangements in Scotland for tax, spending and borrowing.

3.4 **Spending** – Under the current devolution settlement, the Scottish Parliament and Scottish Government have a significant degree of spending autonomy both in terms of the size of its spending remit and the ability to determine policy priorities and strategies. For example, the Scottish Government has significant responsibility for the allocation of public sector expenditure in Scotland – accounting for approximately 70% of total identifiable public sector expenditure for Scotland in 2006/07[23].

3.5 The current arrangements grant the Scottish Government responsibility for a number of policy areas that affect Scotland's long-term economic performance, such as education, transport, planning and economic development. Within its expenditure remit, the Scottish Government is able to determine both the policy mix and specific policy initiatives giving a degree of real autonomy over devolved policies.

[22] Scotland Act 1998, c.46 - http://www.opsi.gov.uk/Acts/acts1998/ukpga_19980046_en_1
[23] Government Expenditure and Revenue Scotland (GERS) 2006/07, Table 6.8, page 60. http://www.scotland.gov.uk/Topics/Economy/Key-Publications/GERS.

3.6 However, responsibility for several key areas of economic policy and government expenditure more generally remain largely reserved to the UK. These include science and innovation, social security, child support and pensions, foreign affairs, defence, employment law and financial regulation.

3.7 **Tax Revenue** – In contrast to the degree of spending autonomy, the Scottish Parliament has only limited revenue raising capacity through taxation. The instruments available are:

- local taxation (e.g. council tax);
- business rates; and
- the ability to vary the basic rate of UK income tax by up to 3 pence (the Scottish Variable Rate – 'SVR')[24].

3.8 Under the current arrangements, the majority of Scottish Government spending is financed by the Scottish Block Grant which is determined in the main by operation of the Barnett Formula. In effect, the vast majority of tax revenues raised in Scotland are set and collected at the UK level before the UK Government determines how much of this is reallocated back to Scotland via the Scottish Block Grant (see Box 3).

Box 3 – The Barnett Formula

The Barnett Formula is the method used by the UK Government to determine changes in the budgets of the Scottish Government, Welsh Assembly Government and Northern Ireland Executive. It was introduced in the 1970s and has since remained largely unchanged. Under the formula, changes in the Scottish Government's Budget are determined by increases or decreases in spending in Whitehall Departments on programmes for which responsibility in Scotland is devolved.

The formula applies to Scottish Government Departmental Expenditure Limit (DEL) funding which accounted for approximately 85% of Scottish Government spending in 2008/09 (£28 billion out of £33.3 billion)[25]. It determines changes to the Scottish Budgetary position, not the total level of the block grant.

The following factors determine the calculation made for each departmental programme in DEL which then underpins the change to the Scottish Government's Budget:

- the quantity of the change in planned spending by UK Government (Whitehall) Departments;
- the extent to which the relevant UK Government departmental programme is comparable with the services carried out in Scotland; and
- Scotland's population as a proportion of England, England and Wales or Great Britain as appropriate. The population projections used reflect the latest available mid-year estimates published by the Office for National Statistics (ONS).

It is then for the Scottish Parliament and Scottish Government to allocate spending within that budget according to their own priorities.

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[24] It is estimated that a one pence change in the SVR would be worth approximately plus or minus £380 million in 2008/09 and £400 million in 2009/10. (Source: HM Treasury Budget 2008)
[25] Scottish Budget – Spending Review 2007 - http://www.scotland.gov.uk/Publications/2007/11/13092240/0

3.9 **Borrowing** – The current devolution settlement provides no authority for the Scottish Parliament to sanction meaningful borrowing by the Scottish Government. There is the opportunity for short-term borrowing sufficient to cover "a temporary excess of sums paid out of the Scottish Consolidated Fund over sums paid into the Fund" or for "providing a working balance in the Fund". Any such borrowings may only be from HM Treasury[26].

3.10 Local authorities in Scotland do have the autonomy to borrow. The Scottish Government funds the debt servicing costs of some of this borrowing, known as "supported borrowing", via the Revenue Support Grant whilst the unsupported borrowing element, arranged under the Prudential Regime, is financed through local authorities' own general resources. The Northern Ireland Executive also has limited borrowing powers.

3.11 Further afield, most other devolved governments with comparable levels of policy autonomy have the authority to borrow in order to facilitate fiscal planning and management of cash flows as well as financing long-term investments and economic strategies[27]. For example, U.S. States and Canadian Provinces have powers to borrow, where bond issuances – particularly to finance infrastructure and capital spending like bridges and schools – are common[28].

Scotland's Current Fiscal Position

3.12 As highlighted above, the current economic climate has weakened fiscal positions around the world.

3.13 The recent Government Expenditure and Revenue Scotland (GERS) report highlighted that in 2006/07, the estimated current budget balance for the public sector in Scotland was a surplus of £0.8 billion (0.7% of GDP) including an estimated geographical share of North Sea revenue. The equivalent UK current budget position, including 100% of all North Sea revenue, was a deficit of £4.3 billion (or 0.3% of GDP)[29].

3.14 Since 1976/77, the UK Government has raised approximately £155 billion in direct tax revenue from oil and gas production. Adjusted for inflation, this is equivalent to £269 billion (2008 prices); or approximately eight times the annual Scottish Government Budget. These revenues have gone directly into the UK Exchequer, with successive governments using the windfall to fund public spending and to seek to reduce taxation across the UK. Unlike other countries with substantial oil and gas reserves, the UK Government has yet to establish an oil fund where a proportion of the proceeds from the country's oil and gas production could be invested over the long-term.

3.15 Norway's oil fund, known as 'The Government Pension Fund – Global', was established in 1990 however, the first net transfer to the fund was not made until 1996[30]. It is now the second largest wealth fund in the world and as at end of September 2008 it was valued at NOK 2,120 billion[31] – approximately £200 billion.

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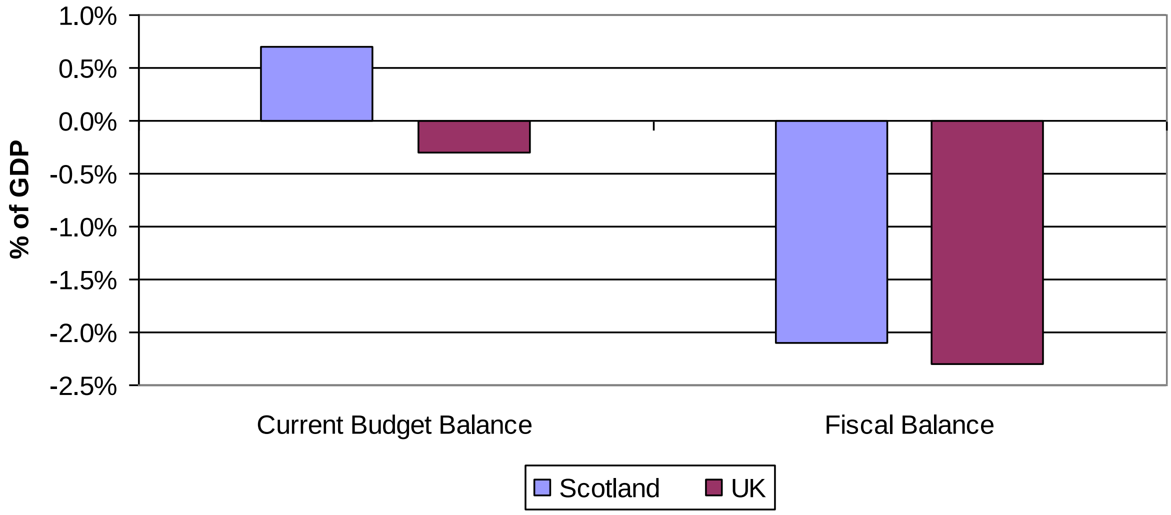
[26] Scotland Act 1998, section 66 and 67 - http://www.opsi.gov.uk/Acts/acts1998/ukpga_19980046_en_1
[27] For a review of borrowing autonomy in other countries see Debrun et al., 2008, "Tied to the mast? National fiscal rules in the European Union", Economic Policy, Vol. 23, pp. 297 – 362 and Rodden J., 2002, "The Dilemna of Fiscal Federalism: Grants and Fiscal Performance around the World," American Journal of Political Science Vol. 46, pp. 670 – 687.
[28] CityMayors.com - 14 May 2008 - http://www.citymayors.com/finance/bonds.html#Anchor-47383
[29] HM Treasury Budget 2008
[30] The Government Pension Fund of Norway is made up of two elements: The Government Pension Fund – Global (the oil fund) and The Government Pension Fund – Norway. The latter is a general National Insurance scheme. For more information see http://www.government.no/gpf
[31] NBIM Quarterly Report Q3, 2008 – Table 5.1 http://www.norges-bank.no/templates/reportroot____65330.aspx

Chart 1 – Scotland's Current Budget Balance and Net Fiscal Position: 2006/07



Source: Government Expenditure and Revenue Scotland 2006/07

3.16 In 2006/07, the estimated overall net fiscal balance in Scotland, that is the estimated current budget balance plus net capital investment, was a deficit of £2.7 billion (2.1% of GDP) when an estimated geographical share of North Sea revenue is included. This is broadly in line with the average fiscal balance in the OECD which for the years 2005 to 2007 inclusive, was a deficit of 1.8% of GDP[32].

3.17 The equivalent UK position in 2006/07 including 100% of all North Sea revenue, referred to as 'net borrowing', was a deficit of £30.1 billion (or 2.3% of GDP)[33]. Other large OECD countries also operate deficits: France a deficit of 2.7%, Japan a deficit of 2.4% and the USA a deficit 2.9% of GDP in 2007[34].

3.18 The GERS estimates tells us that Scotland was in a relatively stronger fiscal position in 2006/07, although it does not tell us what the fiscal position of Scotland would be under alternative fiscal structures. Under new fiscal arrangements, Scotland would have the opportunity to make choices regarding the levels of UK-wide expenditures such as welfare payments, foreign affairs and energy policy and take responsibility for ensuring that these were appropriately financed. Short of full independence, this may involve Scotland following the approach adopted in the Basque Country by raising and spending its own resources, before contributing to the UK level for certain 'national' expenditures such as defence.

[32] OECD Economic Outlook, Number 84, Organisation for Economic Co-operation and Development
[33] HM Treasury Budget 2008.
[34] OECD Economic Outlook, Number 84, December, Organisation for Economic Co-operation and Development: It should be noted that fiscal balances across the world have deteriorated significantly in recent months as government's finance bank recapitalisation and fiscal stimulus programmes.

Scotland's Current Monetary Policy Framework

3.19 Under the current constitutional settlement, monetary policy is fully reserved and conducted through the independent Bank of England. The Bank of England sets interest rates, conducts open market operations in the money markets and manages the UK's foreign exchange reserves. The monetary policy remit of the Bank of England is to deliver price stability, as defined by the UK Government's inflation target of 2%, measured by the Consumer Prices Index (CPI). The UK currently operates under a flexible exchange rate regime independent of other countries. In contrast, many European countries are part of the European Monetary Union and share a common currency, the Euro.

Scotland's Current Industrial Policy and Regulatory Framework

3.20 In addition to fiscal and monetary policies, other important economic policy levers are also reserved to the UK Government, with the effect that the UK remains largely responsible for the framework for economic regulation in Scotland. Key reserved functions include:

- energy policy, including the oil and gas sector;
- competition policy;
- company law;
- economic regulation of utilities (e.g. telecommunications, broadcasting and energy);
- financial services and regulation of financial markets;
- consumer protection and product and trading standards; and
- policies affecting the labour market, including employment law and migration.

3.21 These are significant responsibilities which have a considerable bearing on the performance and the growth potential of the Scottish economy. Decisions in these areas by the UK Government and the EU can also have important consequences for fiscal policy, at both a UK level and in Scotland. For example, decisions made by UK Ministers on labour market policy, and particularly on migration, can have an important influence on demand for public services and the size of the tax base.

Constraints on Scotland within the Current Framework

3.22 The current devolution settlement should in theory provide a stable revenue stream for the Scottish Government as the majority of funding is typically allocated for a three-year period. In practice however, this is not always the case, as unilateral changes at the UK level can significantly impact upon anticipated future funding streams. For example, decisions taken by the UK Government at the 2008 PBR will serve to reduce the Budget of the Scottish Government between 2010 and 2012 from that originally planned. While exact details of the final financial impact are as yet unknown, the total effect may be as large as £1 billion over the entire period.

3.23 Moreover, we believe that there are a significant number of more general limitations to the current framework which constrain the autonomy of the Scottish Parliament and the ability of the Scottish Government to generate a step-change in sustainable economic growth:

- While the Scottish Government has significant levers to shape spending programmes, for example, on education and skills, it lacks the ability to shape the regulatory and tax environment, levers that are seen as vital to boosting Scotland's **long-term competitiveness**. For example, under the current arrangements, the Scottish Government does not have the authority to put in place a more competitive corporation tax structure – a policy that is viewed by many, including the Confederation of British Industry (CBI) (2008) and respected academics such as MacDonald and Hallwood (2006) and Greenaway et al. (2006) – as pivotal to economic growth[35]. In addition, commitments to invest in **long-term infrastructure** are constrained by fiscal rules which are determined and revised by the UK Government and not by what is in the best interests of the Scottish economy.

- More generally, the Scottish Government's Budget is determined principally by changes in spending on equivalent programmes in England set by the UK Government and is not directly linked to the preferences of the Scottish population or their willingness to pay for the provision of services. Not only does this lead to **inefficiencies in the decision-making** process from a theoretical point of view, it also fails to give Scottish citizens the ability to choose to vary the level of public spending in any meaningful way beyond that determined by Westminster.

- The current fiscal settlement limits the **short-term flexibility** of the Scottish Government to respond to changes in the economic climate. The Barnett Formula is not linked to economic conditions and borrowing powers are severely limited. Taken together, this means that during economic downturns, the Scottish Government has limited levers to stabilise the Scottish economy through cutting tax or increasing expenditure (for example, expanding investment in infrastructure). In the main, Scotland has to rely principally on action undertaken at the UK level, and this uniform stabilisation policy may not be best suited to Scotland. For example, the Scottish Government believes that the £12 billion cost of reducing VAT to 15% announced by the Chancellor at the 2008 PBR, would have been better spent on increasing net investment as analysis has shown that the net effect in terms of jobs would have been greater. However, Scottish Ministers were not able to make this choice.

- The current framework leaves the Scottish Parliament without responsibility for North Sea revenues preventing the creation of a **Scottish oil fund**. In addition, many of the key levers to tackle environmental issues are reserved, including support for innovation in areas such as carbon capture and storage, environmental regulation and global environmental agreements.

- In recent years, the application of the **Barnett Formula** appears to be partial with some funding subject to 'formula bypass' and with Scotland not always treated in a fair and reasonable manner. An example is the allocation of development and regeneration expenditure tied to the London Olympics and expenditure on prisons in England, from which Scotland did not receive appropriate consequential funding.

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[35] CBI, 2008, "UK Business Tax: A Compelling Case for Change", CBI, March 2008; MacDonald, R., and Hallwood, P., 2006, "The Economic Case for Fiscal Autonomy", Policy Institute, Edinburgh; Greenaway D., Gorg H., and Barry F., 2006, "Assessing the Case for a Differential Rate of Corporation Tax in Northern Ireland", Economic Research Institute of Northern Ireland, November 2006.

- Finally, greater fiscal autonomy could improve **political accountability** and **transparency** by providing a more visible link between expenditure and tax choices. In 2006/07, the Scottish Government was responsible for £29.9 billion of identifiable public expenditure in Scotland but with local authorities only collected approximately £3.6 billion of total revenues through council tax and non-domestic rates[36]. Fiscal autonomy, by linking expenditure with revenue (and/or borrowing), can encourage maximum rigour in the overall budget process of the public sector in Scotland through consideration of both the marginal costs and/or benefits of changes in public spending and taxation. In effect, by forcing Scottish politicians to focus on both sides of the balance sheet – revenues as well as expenditures – it emphasises the need for keeping higher sustainable economic growth at the heart of public policy debates.

Conclusion

3.24 The Scottish Parliament and Scottish Government have spending autonomy over devolved policies; however, this is in stark contrast to the level of revenue and borrowing autonomy, which is severely constrained. In this regard, Scotland stands as a clear outlier in comparison to other countries. Importantly, the Scottish Government has no role in monetary policy and key elements of broader economic policy.

3.25 We believe that the current tax, spending and borrowing arrangements seriously constrain the ability of the Scottish Government to deliver increasing sustainable economic growth. The aim of greater autonomy is to improve resource allocation and incentivise growth; to generate greater public revenues, meaning Scotland could support higher levels of public spending and/or lower taxes in the long-term.

3.26 In light of this, Chapter 4 reviews the options for reform of tax and spending responsibilities in Scotland. These are:

- current framework;
- assigned revenues;
- enhanced devolution;
- devolution max; and
- independence.

[36] Government Expenditure and Revenue Scotland 2006-07 http://www.scotland.gov.uk/Publications/2008/06/18170334/0

4 Devolution of tax and spending: options for reform

Chapter Summary

- The Scottish Government believes that there are five main options for fiscal reform:
    - current framework;
    - assigned revenues;
    - enhanced devolution;
    - devolution max; and
    - independence.
- Each option has different levels of revenue and expenditure autonomy.
- The National Conversation is open to considering all the options for reform.

Introduction

4.1 Having demonstrated the need for improvements to the current arrangements for tax, spending and borrowing in Scotland, this chapter examines the different forms that greater fiscal autonomy can take and the potential options for change.

Definitions of Fiscal Autonomy

4.2 Fiscal autonomy for Scotland is broadly defined as giving **greater** fiscal authority and responsibility to the Scottish Parliament, over the taxes raised in Scotland and over the level of public sector spending and borrowing.

4.3 Given the balance of spending and revenue autonomy at present, the fiscal autonomy debate in Scotland has tended to focus on revenues and the current funding framework for devolved expenditure, the Barnett Formula.

4.4 Greater fiscal autonomy can take a number of forms ranging from changes to the current devolution settlement through to independence. There is clearly a spectrum of possible options, however, for succinctness, five options for reform are explored within this paper:

- current framework;
- assigned revenues;
- enhanced devolution;
- devolution max; and
- independence.

Options for Reform

Current Framework

4.5 Retention of the current framework would see the majority of the Scottish Government Budget financed by a transfer from the UK Government through a Scottish Block Grant. Given the analysis in Chapter 3, the Scottish Government does not foresee this as a realistic option over the long-term because it places a limit on Scottish success and gives no further fiscal responsibility to the Scottish Parliament.

4.6 Within the current framework, the UK Government could decide unilaterally to replace the present funding mechanism, the Barnett Formula, with an alternative grants mechanism whilst still retaining the current range of policy responsibilities. Pressure may well come from outside Scotland to see such a change[37].

4.7 The UK is unique in operating a funding mechanism for the devolved administrations which is based entirely on population shares and historical spending allocations[38]. In most European countries such grants are based on a combination of 'needs assessment' and revenue raising capacity.

4.8 Australia also has a system of grants based on a 'needs assessment', with the funding allocated to states based upon an assessment undertaken by an independent body – the Commonwealth Grants Commission. The Australian model combines both expenditure and revenue measures in assessing the level of grant allocated to each state. This leads to a more sophisticated allocation of funding than the Barnett Formula, though as with any method of intergovernmental transfer, it does have disadvantages[39].

4.9 Therefore, one possibility for reform could be to move towards a revised grant based funding framework which is more closely linked to a 'needs' assessment exercise. In this scenario, the level of funding for the Scottish Government would be linked to pre-determined measures of 'need' and/or revenue capacity including measures of economic activity, geography, demography and assessed 'needs' in key areas of public services such as health care and inequality.

4.10 The Scottish Government believes that there would be significant political pressure to reduce Scotland's Budget. For example, if a 'new' grant mechanism was constructed to more closely equalise devolved expenditure levels between English regions and the countries of the UK, then the block grant transferred to Scotland might decrease, leading to potential real cuts in funding without fully taking into account the full range of Scottish priorities and needs. Moreover, as any such assessment would be largely subjective, alternative assessments using different measures of need would lead to significant variations in funding outcomes, contributing to significant uncertainty in planning future budgets.

4.11 In fact, the HM Treasury publication Public Expenditure Statistical Analyses (2008) shows that for 2006/07 Scotland received less (identifiable) public spending per capita than Northern Ireland and slightly less than London[40]. Furthermore, such figures do not include so-called 'non-identifiable' expenditure which, while for the benefit of the UK as a whole, can have a significant positive impact on the location in which they are actually spent or procured. For example, it is forecast that expenditure in preparation for the 2012 Olympic Games in London, deemed by the UK Government to be for the benefit of the UK as a whole, will rise to approximately £1.5 billion a year for each year in 2008/09 to 2010/11. A significant share of this total spend is on infrastructure, such as new transport links and housing, concentrated in the east end of London.

[37] Mclean I., Lodge G., Schmuecker K., 2008, "Fair Shares? Barnett and the Politics of Public Expenditure", Institute for Public Policy Research
[38] Darby et al., 2003, "Fiscal Federalism in the European Union", in Jan Monnesland (ed.), European Research in Regional Science 13, Special Issue on Regional Public Finance, Pion: London.
[39] McLean, I., "Fiscal Federalism in Australia", Public Administration, Vol. 82, pp. 21-38.
[40] Public Expenditure Statistical Analyses (PESA), 2008, HM Treasury. http://www.hm-treasury.gov.uk/pespub_pesa08.htm

4.12 A number of alternative options lie between independence and devolution max on the one hand and the current fiscal arrangements on the other. Within this spectrum there are a wide range of possible options. These have been examined extensively in the 'Fiscal Federalism' model recommended by the 2006 Steel Commission[41]. It is important to note that not all options necessarily imply an increase in real autonomy and the Scottish Government believes that some options, particularly **assigned revenues**, would in fact diminish devolution.

Assigned Revenues

4.13 Under **assigned revenues**, the budget available to the Scottish Government would be determined by the amount of revenue collected in Scotland. The Scottish Parliament would not have the authority to alter the tax rate or base but would simply be allocated the taxes raised in Scotland with, or without, the addition of a block grant to provide a top-up and/or degree of equalisation. With no ability to change rates on individual taxes or to alter the base upon which the tax is levied, the Scottish Government would not have the authority to pursue distinctive policies relative to the rest of the UK.

4.14 Not only would this represent no material increase in the autonomy or responsibility of the Scottish Parliament but it would leave Scotland in a worse position in terms of funding than under the current framework – especially with regard to risks and uncertainties arising from day to day changes in tax revenues. Without the ability to respond effectively to these risks, such as through changing tax rates and/or the tax base or greater borrowing autonomy, this would have serious implications for the delivery of public services in Scotland. In effect assigned revenues would be little more than Barnett with greater uncertainty and volatility.

4.15 The Scottish Government believes that this option would have detrimental effects on the provision of public services in Scotland and in the ability of the Scottish Government to deliver a stable policy framework to ensure long-term sustainable growth.

Enhanced Devolution

4.16 It is envisaged that **enhanced devolution** would give the Scottish Parliament and Scottish Government a greater degree of revenue responsibility coupled with a smaller fiscal transfer from the UK Government and limited authority to borrow. Particular elements of spending and policy responsibility may also be transferred, for example welfare and/or energy policy, but this would depend on the particular circumstances of the revised framework.

4.17 The revenue aspect of enhanced devolution could take one (or a combination) of many forms. The basic principles behind two likely options are outlined below.

- Under enhanced tax devolution, the Scottish Parliament would be granted the authority to alter the tax rate and/or base for certain taxes, with the UK retaining control of all remaining taxes. This would therefore mean a transfer of some, but not full, fiscal responsibility to the Scottish Parliament. For example, a combination of various business, environmental and personal taxes could be set, collected and administered in Scotland, independently of the rest of the UK – with the UK Government retaining responsibility for all remaining sources of revenue. This model is used extensively elsewhere. For example in Canada, Provinces

[41] Steel Commission, 2006, "Moving to Federalism – A New Settlement for Scotland", Final Report of the Steel Commission to the Scottish Liberal Democrat Spring Conference.

have responsibilities in income tax, consumption tax, natural resource and property taxation amongst others.

- An alternative option would be the creation of tax sharing arrangements between the Scottish and UK Governments. Tax sharing occurs when two or more tiers of government split the total national tax yield from a particular tax. For example, the UK Government could conceivably receive 50% of total Scottish income tax receipts for spending on reserved issues with the Scottish Government receiving the remaining 50% to finance devolved spending. Within their respective allocated share, each layer of government could be granted limited authority to vary the tax rate or base. Without this additional policy option, tax sharing would not necessarily increase autonomy and would be more akin to partial assigned revenues. Tax sharing is a popular system of government finance in a number of Federal countries, most notably Germany where the revenue raised from certain taxes is shared between the Federal and Länder Governments.

4.18 A key determinant of real autonomy would be the type of taxes devolved. For example, devolution of corporation tax would represent a far more significant step forward in autonomy than devolution of many smaller taxes such as aggregates levy and betting and gaming duties. Any enhanced devolution framework would have to be consistent with EU State Aid law and EU rules and regulations more generally.

4.19 In summary, the more extensive the authority to vary taxes, the greater the degree of actual fiscal autonomy provided by enhanced devolution.

4.20 Under either form of enhanced devolution, there would be a strong argument for a proportionate increase in borrowing autonomy, particularly to assist in the management of yearly budgets and cash flows. Borrowing autonomy could take a number of forms including:

- the ability to borrow for certain types of expenditure such as public infrastructure investment but not for others (e.g. current expenditure such as wages and salaries);

- the ability to borrow but subject to limits (e.g. an ‘internal’ UK Growth and Stability Pact); or

- full borrowing autonomy.

4.21 In their first annual report, the Scottish Council of Economic Advisers recommended that the Scottish Government explored the possibility of new means of borrowing to help finance public sector infrastructure. In addition, the Council took the view that off-balance sheet transactions should be avoided in favour of cheaper and more transparent methods of financing[42].

[42] The First Annual Report of the Scottish Council of Economic Advisors - http://www.scotland.gov.uk/Publications/2008/12/04092147/0

'Devolution Max'

4.22 **Devolution max** – full fiscal autonomy within the UK – would make the Scottish Parliament and Scottish Government responsible for raising, collecting and administering all (or the vast majority of) revenues in Scotland and the vast majority of spending for Scotland.

4.23 By collecting all tax revenues in Scotland, a payment from Edinburgh to London would be required to cover common UK public goods and services (i.e. 'shared services'). The range of services included in this basket of 'shared services', how they would be paid for, and the authority the Scottish Parliament would have over such policies, would be subject to negotiation at the time of any revised settlement. In essence, this framework is the maximum form of tax and policy devolution short of independence.

4.24 This option broadly reflects the system in Spain for the Basque Country and Navarre. Here, the devolved administrations have responsibility for raising and collecting all direct taxes, including corporation tax, but to conform with EU legislation and retain a largely harmonised social security system, indirect taxes and payroll taxes remain centralised. In addition, the Basque and Navarre Governments pay a contribution to Madrid (the 'cupo') for centralised services such as defence and foreign affairs. The two regions have used their powers to lower certain taxes below that of the rest of Spain, including creating a more competitive tax regime relative to the rest of Spain.

4.25 Whilst devolution max would give the Scottish Parliament greater responsibility for economic policy, a number of factors would continue to constrain fiscal policy under this framework:

- **Intra-national rules and guidelines** – In particular, EU laws governing taxation policy both between and within Member States (including EU State Aid Laws). For example, EU directives on harmonisation of sales taxes would require that Scotland did not diverge from UK VAT policy (including rates, allowances and derogations).

- **Rules/agreements with UK Government** – In practice, it is likely that even with apparently full fiscal autonomy a range of rules and commitments may exist which are likely to constrain the Scottish Government's ability to pursue fiscal policy that was significantly different from elsewhere in the UK[43]. These rules might be explicit – for example, limits on annual borrowing requirements – or implicit – as in the case of the 'economic agreement' governing fiscal policy in the Basque Country. Here a series of general principles guarantees a degree of harmonisation between the Basque tax system and the system in the rest of Spain[44].

- **Economic Policy** – While **devolution max** would convey significant fiscal autonomy on the Scottish Parliament, without independence it is likely that certain key aspects of economic policy would remain reserved. For example, financial regulation, employment and competition law are likely to remain centralised at the UK level. Monetary policy would also continue to be set for the UK as a whole.

[43] SCDI (2006) identifies a range of economic and arguably more importantly, a range of political constraints that may limit the degree of de facto fiscal autonomy – SCDI, 2006, "Scotland's Economy – The Fiscal Debate", Scottish Council for Development and Industry.

[44] Basque Government - Economic Agreement (2002)
http://www.lehendakaritza.ejgv.euskadi.net/r48-2312/en/contenidos/informacion/concierto_economico/en_467/adjuntos/concierto_economico_i.doc

Independence

4.26 **Independence** – full fiscal autonomy – would see Scotland with the same responsibility for fiscal and economic policy as other, similar countries.

4.27 This option would return responsibility for raising and collecting all revenues (including North Sea revenues) to the Scottish Parliament, as well as the full range of government expenditures (including welfare and defence). As the government of an independent nation, the Scottish Government would be able to borrow on international capital markets subject to the usual free market constraints faced by other governments.

4.28 Independence would also mean that the Scottish Parliament could determine how it wished monetary policy to be conducted in Scotland. The Scottish Government would retain Sterling on independence and a decision on joining the Euro would be taken based upon economic conditions and only with the approval of the Scottish people in a referendum. This would mean that the decision on the best monetary policy framework for Scotland would be determined by what is in the best interests for Scotland rather than the current situation where the UK Government makes the decision for Scotland.

4.29 In practice, fiscal policy under independence would be subject to intra-national rules and regulations, such as EU directives on competition, tax harmonisation and the EU Single Market. However, unlike the other options outlined above, Scotland's relationship with the international economic and financial community would take place within the context of Scotland acting as an independent sovereign state. Scotland would therefore have the ability to shape and influence policy at the international level (e.g. EU fisheries policy) – something that is currently not possible.

Summary

4.30 The following table provides a brief summary of the options considered in this chapter:

Table 2 – Fiscal Autonomy: Options for Reform

	Principal funding source	Revenue autonomy	Expenditure autonomy
Current framework	Block Grant (Barnett)	Low autonomy	Limited to devolved responsibilities
Assigned revenues	Tax assignment	Low/diminished Autonomy	Limited to devolved responsibilities
Enhanced devolution	Mixture of shared taxes/devolution of taxes	Limited autonomy (at margin)	Limited to devolved responsibilities
Devolution max	All (or vast majority) of taxes devolved	Significant (subject to EU and UK laws)	Full (except for 'shared services' and certain aspects of economic policy)
Independence	Full spectrum of public finances	Full	Full

4.31 The next chapter will review how well these different options for reform help Scotland to realise its economic potential.

5 Delivering growth: how the options compare

Chapter Summary

- The motivation for fiscal reform in Scotland is to create a fiscal framework which will give Scotland greater ability to increase sustainable economic growth.

- The Scottish Government believes that the best fiscal structure for Scotland's future is one that will lead to the establishment of a fiscal policy making environment which is best placed to meet the challenges of ensuring **long-term competitiveness** and **responsiveness**.

- To deliver this, options for reform are assessed against three key criteria:
  - enhanced efficiency;
  - greater accountability and transparency; and
  - sustainability.

- The Scottish Government believes that the only option which will deliver the framework to support the levels of higher long-term sustainable economic growth that Scotland should enjoy is full fiscal autonomy in an independent Scotland.

Introduction

5.1 This chapter considers the options for reform and reviews them against a number of key criteria to establish how effective each option would be in achieving the Scottish Government's Purpose and enabling Scotland to realise its full potential.

Assessment of Options for Reform

5.2 The Scottish Government's core Purpose is to create a more successful country, with opportunities for all of Scotland to flourish through increasing sustainable economic growth. Any changes to the fiscal framework for Scotland must contribute to the delivery of the Purpose.

5.3 Economic growth is the key driver of prosperity and sustainability over the long-term. Faster economic growth means more resources can be devoted to public services and/or cuts in taxation.

5.4 The Scottish Government believes that the best fiscal structure to achieve this is one that will lead to the creation of a fiscal policy making environment which is best placed to meet the challenges of ensuring:

- **long-term competitiveness** – maximising opportunities to raise productivity, competitiveness and economic growth over the long-term; and

- **responsiveness** – maximising opportunities to respond swiftly and effectively to changes in circumstances.

Criteria for Comparing Options for Reform

5.5 To deliver a fiscal framework for Scotland that best meets these two objectives there are three key criteria against which each of the options outlined in Chapter 4 are compared. The three criteria are:

- **Enhanced Efficiency** – A fiscal framework that encourages economic efficiency is vital to ensuring that Scotland becomes a richer society and economy. Changes to the fiscal framework should create opportunities for raising efficiency and enhancing Scotland's competitive advantage.

- **Greater Accountability and Transparency** – Accountability and transparency are vital in ensuring public support and trust in the political system and incentivising best practice, better governance and policy actions. Changes to the fiscal framework should enhance accountability and transparency and create incentives for delivering best practice.

- **Sustainability** – Changes to the fiscal framework should show the cost effectiveness of the funding mechanism and at the same time ensure affordability of tax and spending policies both in the short and long-term.

Comparing the Options for Reform

5.6 The following section examines how each option for reform demonstrates the ability to meet these key criteria and the extent to which it assists in the delivery of increased sustainable economic growth. The concluding chapter presents a summary of the options for reform and sets out the preferred position of the Scottish Government.

Enhanced Efficiency

Enhanced Efficiency *– A fiscal framework that encourages efficiency is vital to ensuring Scotland becomes a richer society and economy. Changes to the fiscal framework should create opportunities for raising efficiency and enhancing Scotland's competitive advantage.*

5.7 In order to promote long-term growth and short-term flexibility there are three critical elements to be considered in relation to enhanced economic efficiency:

- greater autonomy to tailor policies to match preferences;
- opportunities to extend competitive advantages; and
- efficiency in delivery of public services.

Greater autonomy to tailor policies

5.8 A basic principle underlying the economic theory of optimal public finance is the belief that devolved governments are best placed to tailor policies to match the particular preferences and needs of their constituents[45]. By matching policy instruments to the location which captures the benefits and costs of each policy instrument, optimal efficiency in policy setting can be achieved. In contrast, a 'one-size-fits-all' fiscal policy strategy is unable to take full advantage of differences between countries or regions.

[45] Oates W., 1999, 'An Essay on Fiscal Federalism', Journal of Economic Literature, Vol. 37, September, pp.1120-1149.

5.9 We believe that enabling the Scottish Parliament to have greater autonomy to tailor policies to match the particular preferences and needs of the Scottish people can generate a more efficient allocation of spending and taxation and hence lead to an improvement in welfare. Indeed to date, devolution has enabled policies on business rates, prescription charges and hospital car park charges to be different in Scotland from those in England. Further devolution could extend these policy differences into other areas, such as increasing the state pension in Scotland or halting the introduction of identity cards. Where the Scottish people believed that there were shared benefits and costs of certain policies between Scotland and other parts of the UK, there could be an advantage from the establishment of appropriate economic and fiscal partnerships.

5.10 This view has some support in the academic literature. For example, Brueckner (2006) has assessed the merits of policy differentials within a centralised economy and found that (on the assumption that there are already differences between regions), regions have the potential to grow faster with appropriately targeted policies arising from greater decentralisation than under a 'one-size fits all' centralised policy[46].

5.11 As highlighted in Chapter 3, within the **current framework** of devolved powers, the Scottish Parliament has significant autonomy over devolved policies and flexibility to decide the allocation of programme spending.

5.12 However a range of policies, particularly in respect of taxation and in key areas of spending and economic policy, remain reserved to Westminster. In addition, the lack of significant revenue autonomy means that the Scottish Government only has limited opportunities to vary the overall size of the Scottish Budget in a meaningful way – such as via tax cuts or increased levels of investment in public services or infrastructure – without corresponding cuts elsewhere.

5.13 Under **assigned revenues**, there would be no additional opportunity for distinctive policies to be pursued in Scotland compared with the rest of the UK and, in this regard, there would be no material increase in the freedom to tailor policies to match the preferences of the Scottish people or particular circumstances unique to Scotland.

5.14 The specific design of an **enhanced devolution** framework would determine whether there was an improved range of options available to the Scottish Parliament. In general, greater tax devolution would, at the margin, increase the range of revenue policy options open to the Scottish Parliament. Similarly, provided authority to change policy on any shared taxes was devolved, a degree of autonomy would be achieved under tax sharing.

5.15 The 'type' of taxes devolved in any revised framework would be an important determinant of the degree of 'real' autonomy. Clearly some elements of government expenditure and taxation, such as income tax and the welfare state, have greater implications for the people of Scotland and the Scottish economy than others. Overall however, the opportunities for the Scottish Government to set policies specifically for the benefit of the Scottish economy and the people of Scotland would remain constrained.

[46] Brueckner J., 2006, "Fiscal Federalism and Economic Growth", Journal of Public Economics, Vol. 90, pp. 2107-2120.

5.16 **Devolution max** would provide significant autonomy in the setting of fiscal policies to match the preferences and circumstances of the people of Scotland and would represent a significant step forward. However, as highlighted in Chapter 4, this is still likely to be subject to constraints. Negotiation of a revised fiscal settlement within the UK, coupled with EU rules and regulations governing tax and spending policies of sub-central governments, would impose limitations on the autonomy to vary policy. Furthermore, while devolution of fiscal policy would be at a near maximum, many other aspects of economic, employment and regulatory policy may remain reserved unless devolved separately.

5.17 **Independence** however, would put Scotland in the same position as other countries and allow the full range of fiscal and economic policies to be set to meet the objectives and needs of the people of Scotland and the Scottish economy. We believe that this would allow maximum opportunity to take advantage of the economic efficiency gains that could be made from tailoring policies solely in the best interests of Scotland.

Opportunities to extend competitive advantages

5.18 Public policies have an important role to play in boosting sustainable economic growth. Investments in capital, both physical and human, and research and development are essential drivers of Scottish productivity, competitiveness and sustainable economic growth.

5.19 Greater decentralisation has the potential to boost sustainable economic growth by creating the opportunity for the Scottish Parliament to shape the regulatory framework, the taxation environment and the supply side of the economy, to make the most of Scotland's comparative advantages, to address any specific skills shortages and to build upon and correct any infrastructure strengths and weaknesses.

5.20 The establishment of clusters and key sectors is also vital to sustainable economic growth. The Nobel laureate Paul Krugman, in his theory of New Economic Geography[47], has stressed the importance of the growth and development of clusters and key sectors in developing networks, enhancing economies of scale, creating spill-overs and ultimately boosting economic growth. Once again, government policy has an important role to play in ensuring that regions and countries are well placed to take advantage of such opportunities.

5.21 Under the **current framework**, the Scottish Government has extensive but not complete responsibility for a number of key elements of supply-side economic policy, including education, skills and infrastructure, which are believed to be important determinants of competitiveness and long-term economic growth. The *Government Economic Strategy* sets out how the Government intends to use these levers to boost Scotland's economic growth. Already a number of policies have been put in place such as the Small Business Bonus Scheme and the abolition of tolls on the Forth and Tay Road Bridges. However, responsibility for a number of critical elements of policy which determine Scotland's competitiveness, such as establishing the competition, regulatory and business tax environment, remain reserved to the UK Government.

5.22 **Assigned revenues**, where the Scottish Government would simply be allocated UK taxes raised in Scotland, would offer no opportunities to enhance Scotland's competitive advantage. The actual levers of competitiveness, that is the ability to change tax and economic policy, would remain reserved.

[47] Krugman P., 1991, "Increasing Returns and Economic Geography", Journal of Political Economy, Vol. 99, pp. 483 – 499.

5.23 **Enhanced devolution** would, at the margin, increase the range of policy options available to boost Scotland's competitive advantage, provided that any revised fiscal settlement involved an element of real policy autonomy of important taxes and key areas of economic policy. However, this is not guaranteed and key elements of competitiveness could well remain reserved to the UK Government. For example, the UK Government has, despite widespread support, chosen to reject recommendations to lower the rate of corporation tax in Northern Ireland to a level that is comparable with that levied in the Republic of Ireland[48].

5.24 **Devolution max** and **independence** would increase the policy opportunities available to the Scottish Government. Both would allow fiscal policies to be set more efficiently by building on any strengths and addressing any weaknesses in the Scottish economy. Opportunities to improve competitiveness would therefore be greater.

5.25 However, short of full independence there may well be constraints in the ability to set a tax structure that differed significantly from that of the rest of the UK. With **devolution max**, policy opportunities and choices would be subject to constraints. For example, in Spain the 'economic agreement' between the Basque Country and Madrid contains a number of general principles which the Basque Country must adhere to, which are designed to ensure a degree of harmonisation between the Basque tax system and that in the rest of Spain. In addition, monetary policy would continue to be set at the UK level.

5.26 Once again, we believe that only **independence** would offer the Scottish Government the widest set of fiscal and economic policy levers to enhance Scotland's competitive edge and deliver increased and sustainable economic growth. Enhancing Scotland's competitive advantage would be the responsibility of the Scottish Parliament and Scottish Government, and policies and strategies could be tailored to grow the Scottish economy. In this scenario, Scotland would also have the opportunity to contribute to the shaping of policy at the European level as an independent member of the EU. Scotland would also be free to choose an appropriate framework for monetary policy within the wider context of a revised economic strategy for Scotland.

Efficient delivery of public services

5.27 In addition to dictating the range of policy options available to decision makers, economic theory predicts that the fiscal framework also determines the environment in which policy is set and the efficiency with which it is delivered.

5.28 A key principle for efficient policy delivery is the belief that economically rational decisions are more likely to be adopted when decision-makers are required to balance the marginal benefits of particular spending decisions with their respective marginal costs, and vice versa. The creation of a 'hard' budget constraint is essential in ensuring efficient delivery of public services by making policy makers responsible for balancing the benefits and costs.

5.29 Furthermore, it has been argued that greater devolution can lead to further efficiencies in policy setting by encouraging competition between governments – Brennan and Buchannan (1980)[49]. 'Competitive federalism' whereby governments compete with one another for outside investment, business and jobs can lead to more efficient policy delivery and policy innovations. Taking an example from another policy area, the

[48] Varney Review: "Review of Tax Policy in Northern Ireland" and Greenaway D., Gorg H., and Barry F., 2006, "Assessing the Case for a Differential Rate of Corporation Tax in Northern Ireland", Economic Research Institute of Northern Ireland.
[49] Brennan G., and Buchannan J., 1980, "The Power to Tax", Cambridge University Press, Cambridge.

introduction of the Smoking Ban in Scotland has been adopted elsewhere in the UK – a clear example of a successful policy innovation which has led to benefits not just in Scotland but elsewhere. With greater autonomy, this principle could be extended into areas of economic and tax policy and there are examples of US states clearly competing with each other for business, by capitalising on their particular strengths and trying to create the most attractive environments for both indigenous and outside businesses.

5.30 Some economists have stated that too much competition between governments may create issues for efficient delivery of public services. If under greater fiscal autonomy policies set in Scotland and other parts of the UK (or even other EU countries) diverged significantly, then coordination and dialogue through shared institutions, such as the Joint Ministerial Committee, may be appropriate.

5.31 It has also been claimed that where regulations, tax rates and subsidies differed between Scotland and the UK, this may have implications for efficiency, for example by limiting opportunities to take advantage of economies of scale arising from centralised service provision. However, on the other hand, a heavily centralised administration of fiscal policy may itself carry significant costs and decentralised systems may be more efficient.

5.32 Examples from Ireland suggest that government services can be provided more efficiently than in the UK, when factors such as the high costs in London are taken into account. It is also important to bear in mind that Scotland already pays a full share of the running costs of UK-wide Departments which operate in Westminster. Under greater fiscal autonomy the Scottish Parliament would have greater authority and influence over how these resources were spent.

5.33 A new system of tax administration may impose adjustment costs on firms and individuals as they undertake business in a new tax environment. However, one reform that could be taken under greater devolution would be to move toward a more simplified tax system. The UK system, particularly for business taxation, is regarded by some as complex and administratively burdensome – CBI (2008)[50]. In contrast, a joint study by PWC and the World Bank conducted in 2009 noted that Ireland was one of the highest ranked countries for ease of paying business taxes[51]. This serves to further enhance its competitiveness and attractiveness as a place for conducting business. An absolute priority in undertaking relevant procedures for tax administration in a more fiscally autonomous Scotland would be to minimise the costs involved.

5.34 Under the **current framework**, a balance has to be struck when making decisions on the appropriate policy mix (i.e. increases in a particular element of spending have to be financed by cuts elsewhere). This provides a ‘hard’ budget constraint for spending but the Scottish Parliament has no real authority to determine the overall size of the budget in Scotland. For example, full use of the SVR is estimated to raise approximately £1.2 billion in 2009/10 relative to a budget of over £30 billion. Instead, the amount available to be spent on public services in Scotland is determined principally by changes in spending in England and relevant Barnett ‘consequentials’ and is not necessarily set at a level that maximises efficiency. There is little incentive to spend less than that determined by the block grant and few opportunities to spend more.

[50] CBI, 2008, “UK Business Tax: A Compelling Case for Change”, CBI, March 2008.
[51] PWC/World Bank, 2009, “Paying Taxes: The global picture”, Price Waterhouse Coopers.

5.35 **Assigned revenues**, whereby the Scottish Government would have no authority to increase the level of tax raised, would be unlikely to provide any material change in the incentives for efficient policy delivery as changes in devolved spending would not be directly comparable with costs in terms of increased (or decreased) tax rates. Furthermore, opportunities for the Scottish Government to put in place innovative competitive policies would be prevented.

5.36 **Enhanced devolution** would, at the margin, increase the efficiency of the funding settlement provided that choices could be made between increased or decreased spending and higher or lower taxes. Devolution of particular taxes by offering limited opportunities to vary the level of spending, would provide an improvement in this regard – benefits of spending decisions on devolved policies could be directly linked to additional costs (or reductions) in devolved taxes. By design however, as the full range of policies and choices would not be devolved, the overall scope to deliver maximum efficiencies and innovative policies would be constrained.

5.37 **Devolution max** would have the potential to raise efficiency by providing a 'hard budget' constraint for devolved spending and revenues. This would also enable the Scottish Government to put forward innovative policies that were different to those set across the rest of the UK. Where administrative responsibilities for raising and collecting all government revenues were also devolved, this would create opportunities to put in place a simplified and more efficient collection regime. However, there may be the potential for overlap between devolved and reserved policies which act as constraints on the Scottish Government's ability to deliver real change. In addition, other elements of economic policy may remain reserved even under full fiscal autonomy.

5.38 We believe that only **independence** would provide the greatest degree of efficiency in policy setting in the light of specific preferences and needs for Scotland. Under independence, policy choices would have clear and identifiable implications for revenues (and/or borrowing requirements) and would encourage maximum rigour in the budget process. Policymakers would face maximum incentives to set policy efficiently. A more efficient system of tax administration and public service delivery which we believe would have the potential to more than compensate for any costs of transition. Furthermore, the transfer out of centralised administration in Whitehall to Scotland would also have direct economic effects with the potential creation of jobs and wider economic spill-over effects. This would include the establishment of a capital city of a full member of the European Union together with the increase in international exposure and recognition that this would bring.

Greater Accountability and Transparency

Greater Accountability and Transparency – *Accountability and transparency are vital in ensuring public support and trust in the political system and incentivising best practice, better governance and policy actions. Changes to the fiscal framework should enhance accountability and transparency and create incentives for delivering best practice.*

5.39 Accountability and transparency are vital in providing the appropriate incentives for decision makers to set policy to maximise economic growth. MacDonald and Hallwood (2006)[52] state, "with deficient incentives political decision-makers are unlikely to strive to increase efficiency in the provision of public provided goods, or to try to get the right

[52] MacDonald, R., and Hallwood, P., 2006, "The Economic Case for Fiscal Autonomy", Policy Institute, Edinburgh.

balance between provision of goods and services by the public and private sectors, not to promote economic growth".

5.40 It has been argued that a system of 100% grant finance provides limited incentives to boost growth as the tax and revenue benefits of greater growth will flow to the central government and not to the local level leading to less efficient governance[53]. Greater fiscal autonomy in terms of revenue and borrowing can create a stronger link between the benefits of growth and revenues, improving the incentives for efficient policy making.

5.41 A system that encourages accountability and transparency also ensures that citizens are fully engaged in the democracy and governance of their country. This can have important benefits not just for the economy and the delivery of good policy, but also in terms of social capital. Benefits of social capital include general improvements in the political process (such as monitoring), improved links between community groups and between community groups and the government (De Mello (2000))[54].

Accountability

5.42 It is generally accepted that full accountability can only be achieved when decision makers face tough choices on both spending and revenue and are responsible for the performance of the economy and/or delivery of public services.

5.43 Under the **current framework**, the Scottish Government is responsible for providing a significant amount of the public goods and services for the benefit of Scotland. However, the UK Government also provides a significant amount of spending for Scotland on important services, e.g. international development, defence, social security and broadcasting. Some of the direct economic benefit arising from the provision of such services by the UK Government is likely to be lower than Scotland's population share. For example, a number of UK Government departments providing services across the UK are concentrated in Whitehall which brings with it considerable economic benefit, such as jobs and wider spill-over effects, to London and the South East of England. Furthermore, the UK Government retains a considerable degree of de-facto autonomy over the Scottish Budget through the Barnett Formula and the application of funding rules and guidelines. Overall, accountability for the wider performance of the economy and public sector in Scotland is therefore somewhat blurred by the two-tier nature of the current arrangements. This can lead to a lack of clarity over policy and/or policy outcomes. Short of **independence**, this issue would continue to arise.

5.44 Arguably of more importance is that within the **current framework**, accountability is limited to the allocation of public spending and not to the level of revenue raised in Scotland. By spending, but not directly raising its own revenue, the accountability of the Scottish Parliament has been challenged. Approximately 85% of the Scottish Government's Budget is financed by a block grant. In contrast, sub-central governments in the USA, Canada, Switzerland, Germany and the Scandinavian countries are responsible for raising between 50% and 60% of their own revenues[55].

[53] Rodden J., 2002, "The Dilemna of Fiscal Federalism: Grants and Fiscal Performance around the World," American Journal of Political Science Vol. 46, pp. 670-687.
[54] De Mello L., 2000, "Can Fiscal Decentralisation Strengthen Social Capital", IMF Working Paper, Number 00/129, Washington DC.
[55] IMF Government Financial Statistics Database 2008.

5.45 Any attempt to increase the link between tax revenues raised in Scotland and the annual Scottish Budget should, in theory, increase the degree of accountability and sharpen the incentives for policy makers when setting policy.

5.46 In this regard, **assigned revenues** and **enhanced devolution** may arguably increase incentives for efficient policy delivery, particularly with regard to economic growth, as decisions made on devolved policies would have direct implications for the amount of revenue raised in Scotland. However, a number of key policy choices would remain reserved and would continue to have a direct impact on the size of the devolved budget. In this regard, the Scottish Government and to a lesser extent local authorities, may be held accountable for changes in policy which are the result not of direct policy decisions in Scotland, but changes at the UK level[56]. This lack of clarity would continue to have implications for accountability.

5.47 For example, under assigned revenues the recent decision by the UK Government to temporarily reduce the VAT rate would have immediate implications for the level of revenue raised in Scotland. Without borrowing powers, and without the UK Government taking into consideration the wider implications of such policy announcements, this would translate into an unanticipated cut in the Scottish Budget with immediate implications for the delivery of public services. Assigned revenues may at first glance appear to lead to improvements in accountability but when considered more fully, such effects appear limited and may in certain instances lead to a system which damages accountability.

5.48 Incentives and accountability would clearly be high, but not optimal under **devolution max**. Constraints on the freedom to set policies and in the need to pay for UK-wide ‘shared services’ which may or may not be in the best interests of Scotland, may limit accountability.

5.49 **Independence** where policy makers would be fully responsible for all policy setting and outcomes in Scotland would create a framework of maximum accountability.

Transparency

5.50 Transparency is vital to ensuring that the fiscal framework operates efficiently and makes it easier for decision makers to be held accountable. A key motivation behind the process of greater decentralisation across the world in recent years has been the desire to bring government closer to the people and improve transparency[57].

5.51 The **current framework** is designed to be simple and transparent. However, as highlighted in Chapter 3, the limited public understanding of the Barnett Formula and instances of ‘formula bypass’, coupled with apparent spending differences across regions of the UK, appear to have tarnished the transparency of the system.

5.52 A fiscal framework short of independence may increase or decrease the degree of transparency relative to the current framework but it would depend upon the design. There is scope for simplicity, but also a risk that arrangements may seem opaque, particularly in any remaining funding arrangements with the UK. A complex system of **enhanced devolution** and/or **assigned revenues**, with a mix of devolved taxes, tax assignment, tax sharing, grant finance and reserved taxes could limit transparency.

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[56] For a discussion of the academic literature and the merits of decentralisation in improving accountability – Lockwood B., 2006, “The Political Economy of Decentralisation” in Handbook of Fiscal Federalism (ed. E Ahmad and G. Brosio), Edward Elgar Publishing.

[57] World Bank - Decentralization & Subnational Regional Economics - What, Why, and Where

5.53 Transparency would be more obvious under **devolution max** than the current framework or indeed **enhanced devolution** as there would be clarity over roles and responsibilities of both the Scottish and UK Parliaments. However, to the extent that certain areas of economic policy remained centralised at the UK level and continued to have implications for the conduct of fiscal policy in a fiscally autonomous Scotland, this may impinge on overall transparency. Furthermore, the need for a financial mechanism to allow payments to be made from Scotland to the UK Government for 'national public goods' such as defence and foreign policy may require a complex set of rules and regulations.

5.54 We believe that i**ndependence** would be the most transparent option as there would be clarity between revenues, spending outcomes and economic performance. Responsibility for taking forward Scotland would rest entirely with decision makers in Scotland and there would be maximum clarity over roles and responsibilities.

Sustainability

***Sustainability** – Changes to the fiscal framework should show the cost effectiveness of the funding mechanism and at the same time ensure sustainability of spending levels both in the short and long-term.*

5.55 There are three critical elements to be considered in relation to sustainability:

- macroeconomic stability;
- budgetary stability; and
- affordability.

Macroeconomic stability

5.56 The ability to respond flexibly to changing economic needs and circumstances is important in determining the ability of a country to stabilise its economy in the short-term as well as protecting long-term sustainability[58].

5.57 This is especially important during periods of economic uncertainty. The ability to respond swiftly and decisively to short-term economic pressures and challenges is vital to minimise negative shocks to growth, jobs and investment, and enable a stronger, faster recovery. As highlighted above, a distinct advantage of greater fiscal autonomy is that policies can be set to address the unique challenges of a particular locality. A 'one-size-fits-all' fiscal policy strategy by definition is unable to do this. Under greater decentralisation, action may be required to ensure that policies set at the sub-central level do not conflict either with each other or with central government efforts to stabilise the economy. This may point toward the creation of joint institutions which could coordinate certain aspects of policy and agreement on possible fiscal rules.

[58] There have been few formal studies of the relationship between fiscal decentralisation and macroeconomic stability. Those that have been undertaken focus on large Federal countries and their applicability to the Scottish case is limited – Rodden J., and Wibbels E., 2002, "Beyond the Fiction of Federalism: Macroeconomic Management in Multi-Tiered Systems", World Politics, Vol. 54, pp. 494 – 531.

5.58 As recent events have demonstrated the economy is always exposed to a level of macroeconomic variability. The Scottish Government believes that what is important for Scotland to consider is who is best placed to meet such challenges – the Scottish Government with the full range of levers focussed entirely on what is best for the Scottish people and Scottish economy or the UK Government with a 'one size fits all' policy for the entire UK. All other independent countries are currently taking action to address the consequences of the downturn and putting in place policies and new economic frameworks that will ensure that they are best placed to take advantage of new opportunities that will arise when the world economy recovers.

5.59 Under the **current framework**, responsibility for macroeconomic stability rests almost entirely with the UK Government. Although in some instances pooling of risk can be an advantage, a centralised stabilisation policy limits the flexibility of public policy in Scotland to respond at a distinctive Scottish level to changes in the macroeconomic climate or to respond to particular expenditure pressures. The Scottish Government currently has no borrowing authority to provide a stimulus to investment, jobs and output in the light of declining demand; a position that the Scottish Government believes puts Scotland at a distinct disadvantage relative to other countries. More generally, macroeconomic policy solely focussed on what is best for the people of Scotland may quite conceivably take a different path to that taken at the aggregate UK level.

5.60 **Assigned revenues** would expose Scotland to the maximum degree of risk and in many ways this may be worse than the current framework. Annual budgets would be subject to volatility from changes in the economy, but without the additional devolution of levers over tax and spending choices or borrowing autonomy, the Scottish Government would be largely powerless to respond to changes in economic circumstance. In fact, in an economic downturn, and in light of falling tax revenues, a future Scottish Government may face the impossible situation of having to cut expenditure programmes to balance the annual budget at the exact time when a fiscal stimulus is required.

5.61 In theory, **enhanced devolution** and **devolution max** could offer a balance between flexibility, possibly through greater borrowing powers, and UK pooling of risk for example through retention of a UK-wide social security system. However, Scotland would remain wedded to other UK policy choices which may not support stability. The failure of the UK Government to invest for example a proportion of oil revenues for the long-term highlights the obvious limitations on the UK fulfilling this role. There would also be an opportunity to establish a revised framework for ensuring fiscal discipline such as an Internal Stability and Growth Pact. These however are also issues that in theory could be addressed through EU-wide initiatives, such as existing EU regional policy, or in specific partnership arrangements post independence.

5.62 With **independence** the Scottish Parliament would have the full authority and flexibility to put in place the optimal choice of macroeconomic policies to ensure stability, including borrowing. Responsibility for management of any net borrowing and national debt would lie with the Scottish Government. As highlighted above, a number of resource rich countries and regions within countries have established oil funds to assist in stabilising their economies, or to underpin long-term social provision. An oil fund for Scotland could be used in a similar manner. We believe that this would significantly enhance the economic protection currently available to the people of Scotland.

Budgetary Stability

5.63 At present, through the Barnett Formula and the setting of three-year spending plans, the **current framework** provides predictability for the devolved Scottish Budget. In practice however, this is not always the case – as the proposed reduction in future Scottish Government Budgets announced without prior consultation by the Chancellor at the UK PBR has demonstrated. End-year flexibility allows resources to be carried over from one year to the next (and into future spending review periods), but this is also subject to HM Treasury restrictions. Furthermore, in recent years there have been a number of instances where there has been 'formula bypass' where money that we believe should have been allocated to Scotland has been withheld – for example expenditure on prisons in England. Overall, this means that there is in fact a degree of risk and uncertainty in the Scottish Government budget position, despite the theoretical predictability implied by the Barnett Formula.

5.64 **Assigned revenues** would bring significant instability into the Scottish Budget with little or no opportunity to respond and this would carry maximum risk in both the short and long-term. It is inconceivable that some form of stabilisation mechanism, such as a stabilisation grant or borrowing powers would not have to be put in place to mitigate these risks. How such a mechanism was established and who controlled its operation could have significant implications not just for the delivery of public services, but also for the accountability and transparency of the overall framework.

5.65 As with the issue of macroeconomic stability, any form of 'real' increase in revenue decentralisation, such as **devolution max** or **independence**, would require greater responsibility for managing both the revenue and expenditure side of the public sector budget in Scotland.

5.66 The Scottish Government believes that these matters would be managed best in a way that is acceptable to the Scottish people rather than at a UK level. With either devolution max or independence, the Scottish Government would have responsibility for raising its own revenues and making choices on delivery of policy. As we believe that this responsibility rests best with the Scottish people and the Scottish Parliament, we believe that the clear lines of responsibility and budgetary control afforded by **independence** is therefore the best option.

Affordability

5.67 Any re-designed fiscal framework needs to be affordable.

5.68 The relative fiscal strength of a country raises important considerations as to the best design of policy making and fiscal framework. On the one hand, a centralised system can allow for transfers from more prosperous parts of a fiscal union to relatively poorer ones. However, this transfer of resources can lock less well-off areas into permanently lower levels of growth. Long-term economic development cannot be achieved on "a sustainable basis by transfers and redistribution"[59]. A better outcome could be achieved if such a region was given the economic and fiscal tools to target policy to address the strengths and weaknesses in their locality and to become more competitive. Over the medium to long-term, this should serve to enhance affordability. For example, in the 1980s, Ireland was one of the poorest members of the EU, but the setting of a range of policies such as significant investment in infrastructure and

[59] Greenaway D., Gorg H., and Barry F., 2006, "Assessing the Case for a Differential Rate of Corporation Tax in Northern Ireland", Economic Research Institute of Northern Ireland, November 2006 – Page 6.

education and skills, has led to GDP per capita levels which, even taking into consideration current economic challenges, are amongst the highest in the world. Similarly, better-off regions would also be able to take advantage of the opportunities that autonomy brings to build upon and develop their current strengths.

5.69 There has been considerable debate about Scotland's fiscal position under alternative fiscal structures. The most recent GERS report shows that, taking the current fiscal and constitutional framework as given, Scotland had a current budget surplus of £0.8 billion in 2006/07 when a geographical share of North Sea revenues is taken into consideration. In 2006/07, the estimated overall net fiscal balance in Scotland, that is the estimated current budget balance plus net capital investment, was a deficit of £2.7 billion (2.1% of GDP) when an estimated geographical share of North Sea revenues is included. The equivalent UK position including 100% of all North Sea revenues, referred to as 'net borrowing', was a deficit of £30.1 billion (or 2.3% of GDP)[60]. Other large OECD countries also operated deficits in 2007: France a deficit of 2.7%, Japan a deficit of 2.4% and the USA a deficit 2.9% of GDP[61]. As GERS takes the current constitutional and fiscal framework as given, care should be taken in using these figures when attempting to forecast Scotland's fiscal position under alternative fiscal frameworks. The value would depend largely on the policy choices of the government of the day, the economic climate and any settlement of UK assets and liabilities.

5.70 Scotland already pays for UK-wide services such as social security and defence. **Independence** would mean that these expenditures would be handled by the Scottish Parliament rather than by the UK Parliament. This would also allow for different policy choices, where, for example, the Scottish Parliament would have the opportunity to choose not to spend money on nuclear weapons but could instead divert this spending to support the Scottish economy and adopt different policies in other currently reserved areas such as pensions and support for families.

5.71 The greater the level of autonomy offered to the Scottish Parliament, the greater the need for allocation of UK assets and liabilities to Scotland and the rest of the UK. This would include a possible share of UK national debt, other liabilities such as public sector pensions, but also assets such as a geographical share of North Sea revenues and a fair and equitable share of public sector assets such as UK Government buildings.

5.72 Under the **current framework**, the amount of expenditure in Scotland is determined by the Barnett Formula and relevant UK Government expenditures in Scotland such as social security payments. Affordability of public services for Scotland to a large extent is therefore driven by affordability of the UK public finances. Scotland's level of public spending reflects elements such as additional costs of providing public services over more sparsely populated areas and differences in the structure of the public and private sectors in Scotland compared to the rest of the UK[62].

[60] HM Treasury Budget 2008 - www.hm-treasury.gov.uk
[61] OECD Economic Outlook, Number 84, Organisation for Economic Co-operation and Development - www.oecd.org
[62] Government Expenditure and Revenue Scotland, 2006/07 - http://www.scotland.gov.uk/Topics/Economy/Key-Publications/GERS

5.73 Going forward, the UK fiscal position is forecast to deteriorate significantly. Net borrowing is not forecast to return to surplus until 2015/16 at the earliest, resulting in UK Government net debt reaching over £1 trillion in 2012/13[63]. The IFS estimates that it may take over twenty years for net debt to return to pre-crisis levels[64]. This is expected to put significant constraints on public expenditure over the medium term in Scotland and the UK.

5.74 With **assigned revenues** and **enhanced devolution**, short of the transfer of the vast majority of revenues to the Scottish Government, some form of grant mechanism would be required to ensure that the overall budget was sufficient to meet the requirements for financing devolved spending, given that the UK would retain a significant proportion of Scottish revenues.

5.75 The affordability of the funding arrangement over the long-term would arguably be of greatest importance for **devolution max** and **independence**. With **independence**, and to a lesser extent **devolution max**, responsibility for delivery of sound public finances and a robust economic framework over the short and long-term would be the responsibility of the Scottish Government.

5.76 Under devolution max, a payment would be required to be made to the UK Government for delivery of UK national public goods. How this mechanism actually worked in practice would be subject to negotiation at the time of any revised settlement.

5.77 The Scottish Government believes that **independence** would be the optimal environment for greater prosperity. The Scottish Government would commit to set out a clear and detailed budgetary and administration package to govern the transition to independence. Ultimately, the fiscal and economic success of Scotland under independence would depend upon the policy choices of the government and economic performance over the long-term.

Conclusion

5.78 This chapter has explored the options for reform and reviewed them against a number of key criteria to see how effective each option would be in achieving the aim of increasing sustainable economic growth and enable Scotland as a whole to realise its full potential.

5.79 The concluding chapter summarises our review of the options for reform and sets out a way ahead for Scotland through the National Conversation.

[63] Pre-Budget Report (2008), HM Treasury www.hm-treasury.gov.uk – Table B10.
[64] IFS Green Budget 2009, Institute for Fiscal Studies: London www.ifs.org.uk

6 A way ahead for Scotland

Chapter Summary

- This paper has set out the case for new and better fiscal arrangements for Scotland and the main options for reform.
- The National Conversation is the vehicle through which the people of Scotland can discuss real improvements to meet the needs of businesses, families and communities nationwide.
- The view of the Scottish Government is clear. This Government believes that independence is the best way forward for Scotland and would provide the assured constitutional structure to deliver increasing sustainable economic growth.
- The publication of this paper is the next stage in the National Conversation, not the end, and the Scottish Government welcomes views on the issues raised in this publication.

Introduction

6.1 This paper has looked at the main options for improving the fiscal arrangements in Scotland. It has illustrated how each of these options meets the key criteria for reform.

6.2 This chapter provides a summary of each option and concludes that Scotland will only meet its full potential when it has the same range of responsibilities as other successful independent countries. It then goes on to outline a way ahead for Scotland through the National Conversation.

Summary of options for reform

6.3 The five options for reform considered by the paper are:

- current framework;
- assigned revenues;
- enhanced devolution;
- devolution max; and
- independence.

Current Framework

6.4 The Barnett Formula sets a limit on funding available to devolved administrations and determines the Budget of the Scottish Government based on policy priorities elsewhere in the UK. Scotland is dependent on the success or otherwise of the UK's macroeconomic and fiscal policy framework.

6.5 As demonstrated in Chapters 3 and 5, although the current devolution settlement allows significant authority to manage public spending in Scotland, the principal tools of macroeconomic, taxation and regulatory policy are reserved to the UK Government, preventing the Scottish Government using the full range of policies to deliver improved growth. This option is therefore not considered to be a positive option for Scotland.

Assigned Revenues

6.6 Assigned revenues would not represent a material increase in the autonomy of the Scottish Parliament and in many respects would lead to the establishment of a weaker fiscal framework than the current arrangement. It has been argued by some commentators that incentives to grow the economy could be improved. However, there is no evidence that this would indeed be the case, or is not happening under the current arrangement. Indeed within the current framework and without assigned revenues, this Government has put growing the economy at the heart of its policies and its framework for public accountability.

6.7 Dependence upon assigned revenues with no autonomy to respond to changes in economic or financial circumstance would generate maximum risk to the Scottish Budget and delivery of public services in Scotland.

6.8 Therefore in practice, assigned revenues do *not* represent any step forward in devolution and the autonomy of the Scottish Parliament. The principal effect would be a change in accountancy rules which the Scottish Government believes could leave Scotland worse off by creating the appearance of responsibility without any real additional economic levers. This option is not considered a credible proposition for a new Scottish fiscal framework.

Enhanced Devolution

6.9 Under this option, a movement toward enhanced devolution could increase the range of policy opportunities available to the Scottish Parliament provided that it involved a degree of tax devolution (i.e. the ability to vary tax rates/base in Scotland compared with the rest of the UK).

6.10 To an extent, enhanced devolution would represent a step forward in the fiscal framework for Scotland. However, a piecemeal reform would not allow the more substantial opportunities that could come from greater autonomy and it would not match the economic ambitions of Scotland's businesses and citizens.

Devolution Max

6.11 Short of independence this option would create the maximum policy discretion for the Scottish Government to increase sustainable economic growth. It is possible however, that elements of economic policy would remain reserved to the UK Government. This option would involve some additional administrative costs and increased reliance on Scotland's 'own-source' revenue. The fact that policy flexibility could also be increased under this option would enable the Scottish Government to deliver appropriate budgetary arrangements.

6.12 Accountability and efficiency would be high under this option and the expanded devolved budget could increase the opportunities of the Scottish Government to respond to short-term pressures in public spending and the wider economy, leading to greater opportunities to enhance Scotland's potential growth.

6.13 This option is therefore a significant step towards fiscal autonomy. However, short of full independence, this would still constrain long-term growth, to the extent that aspects of tax, spending and borrowing remained reserved to the UK Government.

Independence

6.14 Independence would allow the maximum degree of policy discretion and accountability over fiscal and economic policy. It is the arrangement chosen by similar nations around the world. Like these countries, ensuring sustainability would be Scotland's own responsibility, as would growing the economy and managing the national budget over the short and long-term. Incentives for efficient policy delivery would also be maximised. Crucially, it would give the Scottish Government the full range of economic levers to deliver increased sustainable economic growth.

6.15 The Scottish Government believes that independence is the only option which will enable Scotland to meet its full potential, giving this country the same range of responsibilities as other successful independent countries in Europe and across the world.

Conclusion

6.16 This paper has outlined the case for improving the current fiscal arrangements and the options for reform. It has put forward a fiscal framework that can enhance Scotland's long-term competitiveness and ability to respond swiftly and decisively to short-term economic pressures.

6.17 The view of the Scottish Government is clear. This Government believes that independence is the best way forward for Scotland and would provide the assured constitutional structure to deliver increasing sustainable economic growth.

6.18 Our National Conversation continues. We welcome discussion and debate on these issues and comments on this paper can be made through the National Conversation[65]. Beyond this initial exploration of the options for reform, further papers will be published over the coming months setting out how the Scottish Government would use key additional economic levers to deliver a step change in growth for Scotland.

How to participate in the National Conversation

6.19 The best way to sign up for the National Conversation, or to make suggestions for participation events or methods, is to visit the National Conversation website at www.anationalconversation.com or e-mail joinin@anationalconversation.com.

6.20 Responses can also be sent by post to:

A National Conversation
Constitution Unit
G-A North
Victoria Quay
Edinburgh
EH6 6QQ

[65] Scottish Government – National Conversation - http://www.scotland.gov.uk/Topics/a-national-conversation

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